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FEDERAL RESERVE PRICING POLICY ON CHECK CLEARING SERVICES

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

NINETY-EIGHTH CONGRESS

SECOND SESSION

ON

AN ANALYSIS OF THE PROGRESS THE FEDERAL RESERVE HAS MADE TO FULLY RECOVER ITS CHECK CLEARING COSTS AND TO ASSESS CERTAIN FEDERAL RESERVE ACTIONS THAT HAVE BEEN QUESTIONED BY ITS PRIVATE SECTOR COMPETITORS

APRIL 11, 1984

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FEDERAL RESERVE PRICING POLICY ON CHECK CLEARING SERVICES

WEDNESDAY, APRIL 11, 1984

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, D.C.

The committee met at 9:30 a.m., in room SD–538, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn and Hecht.

OPENING REMARKS OF CHAIRMAN GARN

The CHAIRMAN. The Banking Committee will come to order.

The purpose of this morning's hearing is to consider the General Accounting Office's report and study on Federal Reserve pricing policy.

On April 6, 1983, nine members of the Banking Committee wrote to the General Accounting Office requesting an update of GAO's 1982 report on the Fed's pricing of the check clearing services. Pricing of these services was mandated by the Monetary Control Act of 1980.

Gentlemen, we appreciate you being with us this morning to discuss the report. The first witness is William Anderson, Director, General Government Division, General Accounting Office.

STATEMENT OF WILLIAM ANDERSON, DIRECTOR, GENERAL GOVERNMENT DIVISION, GENERAL ACCOUNTING OFFICE, ACCOMPANIED BY CRAIG SIMMONS, ASSOCIATE DIRECTOR, GAO; AND STEPHEN SWAIN, GAO

Mr. ANDERSON. Thank you, Mr. Chairman. Good morning. Let me introduce the gentlemen at the table with me here. To my right is Craig Simmons. Craig is an associate director in charge of a major new effort that GAO started a couple years ago to be of service to the Congress in financial institutions regulatory matters and banking affairs generally. We are building up a pretty good capacity, hiring some topflight folks from the Fed and other places, economists such as Craig and, to my left, is Steve Swain, who was the person responsible for preparing our report on check clearing services.

I have a full statement I would like to enter into the record, sir, and I have an abbreviated form that will take about 12 to 15 minutes if you can bear with me.

The CHAIRMAN. We will include the full statement in the record.

Mr. ANDERSON. Thank you, sir.

It is a pleasure to be here today to participate in your assessment of the actions the Federal Reserve has taken to price its check clearing services.

As you observed, in your request of April 6, 1983, you asked us to provide an analysis of the progress the Federal Reserve has made to fully recover its check clearing costs since our May 1982 report on the subject. You also asked that we assess certain Federal Reserve actions that have been questioned by its private sector competitors.

Our May 1982 report, sir, was the subject of hearings on the House side and at that time we did observe that the Fed was not recovering all of the costs associated with its check clearing services. So we were rather anxious ourselves to see what had happened since that report was issued.

Since that report was issued nearly 2 years ago, the Fed has changed the way it prices its check clearing services.

AVERAGE REVENUE PER CHECK INCREASED BY 38 PERCENT

During 1983, the Federal Reserve began pricing check float, increased other prices, and experienced changes in its mix of services. Average revenue per check increased by 38 percent over the course of the year. Our analysis indicates that as a result of these changes, there no longer appears to be a subsidy in the pricing of Federal Reserve check clearing services—basically the bottom line of our report, sir.

Certain competitors of the Federal Reserve have raised and continue to raise concerns about the way the central bank has implemented its pricing and check clearing policies under the 1980 act. These concerns fall into two general categories:

One, market advantages that result from the Federal Reserve's central bank status.

Two, subsidy of check clearing operations that may continue because not all associated costs—including and especially the imputed costs for the private sector adjustment factor [PSAF]—have been properly identified.

I will summarize the results of our work as they relate to each of these concerns.

First, about the Fed's national scale of operations. In general, the Federal Reserve in its nationwide system of check clearing facilities does enjoy certain advantages as a result of its central bank status, including a limited authority to use revenue generated from one of its locations to make up for a shortfall that occurs in others. But the Federal Reserve does not enjoy all the advantages. It must, for example, be prepared to serve all financial institutions regardless of how costly serving some may be. Private institutions, on the other hand, can exert more influence over the services they will provide and market their check clearing services as part of a broader array of service lines that would define a total business relationship between respondent and correspondent banks. From our perspective, it is unclear how these comparative advantages balance out.

Specific concerns have been raised by the Federal Reserve's competitors as evidence of the central bank's competitive advantage. They include its move to noon presentment, its prohibition from paying presentment fees, its treatment of clearing balances, and the way it has chosen to price some of its float.

I will present our conclusions on each of these items.

First, noon presentment and presentment fees. The Federal Reserve's 1983 move to noon presentment, a time significantly later than that provided for in most local clearinghouse arrangements, was designed to help speed the collection of checks, thereby facilitating the functioning of the Nation's payment system. But it also represented a significant improvement in the Federal Reserve's ability to compete. Although we believe that the Federal Reserve should have sought public comment on this action at an earlier stage than it did, we found no basis to conclude that the change to noon presentment constituted improper regulatory action.

Because a correspondent bank competitor cannot do what the Federal Reserve did without suffering the repercussion of paying presentment fees, the concerns raised about the move to noon presentment are understandable. The practice of charging presentment fees has been in existence for a long time and is viewed by the banks levying such fees as compensation for costs incurred in paying checks after normal clearinghouse hours.

On the advisability of authorizing Federal Reserve banks to pay presentment fees, we believe a number of unanswered questions exist about how authorizing payment of presentment fees would affect the role and responsibility of the Federal Reserve System and about how a fee system would be administered. For example, since presentment fees vary according to local custom, it is unclear what type of fees would constitute nondiscriminatory charges, and it is also unclear who would decide the level of such fees.

Furthermore, because the Federal Reserve is strictly a presenter and not also a payer of commercial checks, imposition of fees would place it at a disadvantage relative to large bank competitors that both pay and charge presentment fees. Thought needs to be given to whether any of these considerations would adversely affect the functioning of the Nation's payments system.

Our report and full statement observe that to our knowledge local clearinghouses had not changed their hours to more nearly correspond to those adopted by the Federal Reserve. In checking with Federal Reserve officials just before this hearing, we understand that some local clearinghouses have in fact adopted later hours.

Now I'll speak to clearing balances. Under policies expected to change this year—let me emphasize that there will be changes—the Federal Reserve's treatment of clearing balances appears, in most cases, to give it an advantage over private check processors. Other things being equal, balances whose earnings help pay for check clearing services are worth more at a Federal Reserve bank than at a correspondent bank. This is because the correspondent bank has to place 12 percent of all such deposits in a noninterest bearing reserve account. Clearing balances maintained with the Federal Reserve are not subject to this requirement. On March 7, 1984, the Federal Reserve Board approved a proposal that would

equalize the costs of clearing balances at the Federal Reserve with those of correspondent banks.

CHECK FLOAT

Concerns have been expressed that the Federal Reserve has the ability to sustain higher levels of check float than any private institution and thereby enjoys a competitive advantage. While this may have been the case when $4.5 billion in unpriced float existed following passage of the 1980 act, we question whether it is still a significant cause for concern.

As a result of operating improvements and the implementation of pricing, check float fell to an average of $1.2 billion in the fourth quarter of 1983. Now that check float is being priced, the Federal Reserve has every incentive to keep it low in a competitive environment.

Concerns have also been raised about the Federal Reserve's policy of charging banks for float that arises in connection with clearing interterritory checks. In this case the Federal Reserve charges depositing banks for the float arising from their actual deposits. This strikes us as being more equitable than incorporating these costs into uniform, systemwide, unit check clearing prices because some banks have a larger dollar value of float per check processed than others.

OPERATING COSTS

Now I'll speak to operating costs and the private sector adjustment factor. In 1983, the Federal Reserve had about $1 billion in total operating expenses. Of this total, the Federal Reserve's planning and control system, its central accounting system, allocated about $320 million to check clearing. Part of this amount represents direct expenses, about $195 million of the $320 million to be precise. The remainder represents an allocation of support and overhead expenses. We paid particularly close attention to the reasonableness of procedures used to allocate support and overhead expenses because this is an area where judgments come into play. We found that the accounting system rules were to a large extent reasonable and being conformed with. We do not believe that there are glaring expense omissions or understatements that would significantly affect Federal Reserve prices. We actually went into the accounting system and saw how the Federal Reserve allocates various costs to the check clearing process and decided that, in general, they were reasonable.

We further established that even if you took the worst case scenario and assumed that the judgment should be biased in favor of putting more costs onto check clearing, the incremental increase in the price of the services would not have been that much.

The Monetary Control Act requires the Federal Reserve to include in its prices for check clearing an adjustment for the taxes and return on capital that would be incurred by a private firm. Some critics take issue with all the assumptions made and measures used by the Federal Reserve to calculate what is referred to as the private sector adjustment factor, arguing that it should be over three times higher than what the Federal Reserve thinks it should

be. Because there is not a set of firms exactly like the Federal Reserve, disagreements about judgments made are bound to exist.

In October, the Federal Reserve proposed to recover $56 million through the private sector adjustment factor in 1984. After carefully studying the methodology used by the Federal Reserve, considering the returns being realized by organizations such as data processing firms which might be considered comparable to this type of service, and looking at the returns being achieved by American business generally, we concluded that the Federal Reserve in fact was not unreasonable in the way it went about calculating the adjustment factor and the amount of costs assigned to it.

Finally, on the disclosure and guidelines on competitive practices, the Monetary Control Act placed the Federal Reserve in the unique and difficult position of competing directly in its check clearing and other priced services operations with many of the same institutions that it regulates. The Federal Reserve is, however, taking some steps that should help reduce the tensions that can easily be generated by its central bank status. We are encouraged particularly by the action that the Federal Reserve is now taking to disclose more fully its financial and program information as well as its efforts to develop policies defining the bounds of its competitive actions. These steps do not, of course, deal with the basic economic concerns of the correspondent banks but they should be helpful in reducing misunderstandings about how the Federal Reserve is carrying out its responsibilities.

I'll stop there, Mr. Chairman, and we'll try to answer any questions you may have for us.

[The complete statement follows:]

United States General Accounting Office
Washington, D.C. 20551

FOR RELEASE ON DELIVERY
EXPECTED AT 9:30 a.m.
April 11, 1984

STATEMENT OF

WILLIAM J. ANDERSON, DIRECTOR

GENERAL GOVERNMENT DIVISION

BEFORE THE

COMMITTEE ON BANKING, HOUSING,

AND URBAN AFFAIRS

U.S. SENATE

ON

FEDERAL RESERVE PRICING OF ITS CHECK CLEARING SERVICES

Mr. Chairman and Members of the Committee:

It is a pleasure to appear today to participate in your assessment of the actions the Federal Reserve has taken to price its check clearing services. Before the Monetary Control Act of 1980 was passed the Federal Reserve provided check clearing services without charge to its member banks. Following the act's enactment, the Federal Reserve was required to price its services and provide them to all member and nonmember institutions. This expanded the Federal Reserve's potential market for check services but at the same time raised a question about whether its

check processing volume would hold up when the service was no longer free. Direct competition increased between the Federal Reserve and private check clearing institutions and this, in turn, has evoked controversy.

In your request of April 6, 1983, you asked us to provide an analysis of the progress the Federal Reserve has made to fully recover its check clearing costs since our May 1982 report on the subject. You also asked that we assess certain Federal Reserve actions that have been questioned by its private sector competitors. Since your committee and others with an interest in these subjects have been provided with a draft report on our findings, I will very briefly highlight the results of our work.

PROGRESS MADE SINCE 1982
IN RECOVERING COSTS

The Monetary Control Act sets forth the principle that over the long-run the Federal Reserve should price its services to cover three items: (1) its operational costs, (2) its costs associated with float created in the check clearing process, and (3) imputed amounts representing the taxes and the return on capital that would be paid if it were a private sector firm--known as the Private Sector Adjustment Factor or PSAF. In our May 1982 report, we expressed concern about the speed with which the Federal Reserve was approaching full cost recovery. We were particularly concerned about its failure to price or eliminate float in its check clearing operations. At the beginning of 1983 the Federal Reserve's prices were not providing enough revenue to

cover operating expenses and it was still not pricing float, thereby continuing to confer a subsidy on users of its services. During 1983 the Federal Reserve began pricing check float, increased other prices, and experienced changes in its mix of services. Average revenue per check increased by 38 percent over the course of the year.[1] Our analysis indicates that as a result of these changes, total revenues are now covering all costs as well as the PSAF. There no longer appears to be a subsidy in the pricing of Federal Reserve check clearing services.

COMPETITOR'S CONCERNS

Certain competitors of the Federal Reserve have raised concerns about the way the central bank has implemented its pricing and check clearing policies under the 1980 act. These concerns fall into two general categories:

(1) Market advantages that result from the Federal Reserve's central bank status.

(2) Subsidy of check clearing operations that may continue because not all associated costs (including the imputed costs for the PSAF) have been properly identified.

I will discuss the results of our work as they relate to each of these concerns.

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[1]This figure is based on actual data for calendar year 1983 and revised volume data for 1982 that have become available since the draft report was prepared. In the draft report we estimated the comparable figure to be 41 percent.

Concerns About the Federal Reserve's National Scale of Operations

In general, the Federal Reserve does enjoy certain advantages as a result of its central bank status. Its nationwide system of check clearing facilities as compared with the fragmented nature of individual competitor operations no doubt creates advantages that accrue from scope and scale. The most recent authoritative study of the nation's check clearing system showed that in 1979 the Federal Reserve participated in clearing about 60 percent of all checks that were deposited in one bank for payment by another.

The nationwide character of the Federal Reserve System also provides it with a measure of flexibility in how it prices its services. To accomplish full cost recovery for the system as a whole, the price of each and every product the Federal Reserve System offers at each of its 48 locations need not--and probably as a practical matter cannot--be set to recover the estimated fully allocated costs (including the imputed taxes and cost of capital) associated with that particular product. The Federal Reserve System sets its prices with the expectation that excess revenues generated by some products in some locations will be sufficient to offset revenue shortfalls associated with some products offered in the same or other locations. Federal Reserve policies and the discipline of generating enough system-wide revenues to cover system-wide expenses do, however, limit the

flexibility which Federal Reserve banks have in setting product prices. In our view, limited flexibility in setting some prices below fully allocated costs, if done in furtherance of legitimate statutory and regulatory objectives, is consistent with the provisions of the 1980 act.

We think it is also important to point out that the Federal Reserve does not enjoy all the competitive advantages. It must, for example, be prepared to serve all financial institutions regardless of how costly serving some may be. Private institutions on the other hand, have a greater ability to influence the services they will provide. Thus, a private bank can, but a Federal Reserve bank cannot, charge very high prices to discourage demand for services the bank feels do not represent the best use of the bank's resources. Furthermore, unlike its private competitors, the Federal Reserve is not in a position to market its check clearing services as part of a broader array of service lines that would define a total business relationship between respondent and correspondent banks. In this sense the Federal Reserve may have less flexibility in its pricing and in its ability to compete than private sector counterparts. From our perspective, it is unclear how these comparative advantages balance out.

Specific Concerns

Specific concerns have been raised by the Federal Reserve's competitors as evidence of the central bank's competitive

advantage. They include its move to noon presentment, its prohibition from paying presentment fees, its treatment of clearing balances, and the way it has chosen to price some of its float.

Noon Presentment and Presentment Fees. In February 1983, the Federal Reserve began presenting checks for payment as late as 11 a.m., and in June the time was moved to noon. Before the move to noon presentment, the Federal Reserve generally had abided by the earlier presentment deadlines prescribed by clearinghouses in major cities, normally 8 a.m. to 10 a.m. Checks presented after customary clearinghouse deadlines are often subject to fees called presentment fees, that the Federal Reserve, by law, is prohibited from paying. The move to noon presentment, in combination with improved transportation arrangements and later deposit deadlines, was designed to speed the collection of checks thereby facilitating the functioning of the nation's payment system. But it also represented a significant improvement in the Federal Reserve's ability to compete. We found no basis to conclude that the Federal Reserve's change to noon presentment constituted improper regulatory action, but do believe it would have been beneficial if public comment had been invited earlier in the process.

Data that would allow a comprehensive analysis of the effect noon presentment has had on the Federal Reserve's competitors are

not available. There is some evidence, however, that the changes in the Federal Reserve's service have adversely affected at least some of its competitors' activities. The best evidence is that the rate of increase in the number of checks transported by the Federal Reserve after noon presentment began to be implemented was greater than the rate of increase in the number of checks thought to have been written during the period after Federal Reserve policies changed. This result logically implies a reduction in checks transported by other means. Although local clearinghouses could change their rules to permit later presentment times, to our knowledge they have not found it advantageous to do so.

Because a correspondent bank competitor cannot do what the Federal Reserve did without suffering the repercussion of paying presentment fees, the concerns raised about the move to noon presentment are understandable. The practice of charging presentment fees has been in existence for a long time and is viewed by the banks levying such fees as compensation for costs incurred in paying checks after normal clearinghouse hours. We were asked to comment on the advisability of authorizing Federal Reserve banks to pay presentment fees. In principle, subjecting the Federal Reserve System to the same arrangements competitors face has merit. Data unfortunately does not exist that permit a complete description of how presentment fees fit into the overall check collection picture. As indicated in our draft report, however,

we believe a number of unanswered questions exist about how authorizing or requiring payment of presentment fees would affect the role and responsibility of the Federal Reserve System and about how a fee system would be administered.

Presentment fees currently vary according to local custom and in many cases seem to be the result of arrangements negotiated on a case by case basis between banks. In light of this, it is unclear what level of fees would constitute nondiscriminatory charges, and it is also unclear who would decide the level of such fees. If a standard fee were set for the Federal Reserve, would that become the standard for all banks? If the fee the Federal Reserve paid were allowed to vary according to local custom, what opportunities exist for clearinghouses to change the procedures and the costs associated with the check clearing process? Furthermore, because the Federal Reserve is strictly a presenter and not also a payer of commercial checks, would imposition of fees place it at a disadvantage relative to competitors that both pay and charge presentment fees? In deciding whether to authorize or require the Federal Reserve to pay presentment fees we think it would be appropriate to answer as many of these questions as possible to be certain that subjecting the Federal Reserve to such charges would not adversely affect the functioning of the nation's payments system.

Clearing Balances. Under policies soon to be changed, the Federal Reserve's treatment of clearing balances appears, in most

cases, to give it an advantage over private check processors. Other things being equal, balances whose earnings help pay for check clearing services are worth more at a Federal Reserve bank than at a correspondent bank. This is because the correspondent bank has to place 12 percent of all such deposits in a noninterest bearing reserve account. Clearing balances maintained with the Federal Reserve are not subject to this requirement. The Federal Reserve's advantage is, however, to some extent offset because correspondents earn more on the portion of their clearing balances they invest than can the Federal Reserve. Nevertheless, everything considered, it seems appropriate for the Federal Reserve to change its method of calculating the value of its clearing balances to eliminate the apparent advantage that stems from its central bank status.

On March 7, 1984, the Federal Reserve Board approved a proposal to accomplish this change, and this will take effect later on this year. This proposal will increase effective prices to some degree for most of the institutions eligible to deposit checks with the Federal Reserve System for collection. The maximum effective price increase for any one institution that wants to pay for its check clearing services entirely by clearing balance earnings credits is about 13 percent, but the overall effect of the change on average Federal Reserve effective prices will be much less than this amount.

Check Float. Concerns have been expressed that the Federal Reserve has the ability to sustain higher levels of check float than any private institution and thereby enjoys a competitive advantage. While this may have been an important competitive factor when $4.5 billion in unpriced float existed following passage of the 1980 Act, we question whether it is still a significant cause for concern. Because check float is now priced, the Federal Reserve has every incentive to keep it low in a competitive environment.

The Federal Reserve's strategy, which succeeded, was to reduce float before pricing it, thereby minimizing the effect that float pricing would have on the Federal Reserve's customers. As a result of operating improvements and the implementation of pricing, commercial check float fell to an average of $1.2 billion in the fourth quarter of 1983.

Concerns have been raised about the Federal Reserve's policy of charging banks for float that arises in connection with clearing interterritory checks. In this case the Federal Reserve charges depositing banks for the float arising from their actual deposits. This strikes us as being more equitable than incorporating these costs into the unit check clearing prices charged to all banks because some banks in some regions have a larger dollar value of float per check processed than those in other regions. Though this system may be more administratively burdensome than the alternative, this disadvantage is more than offset by its fairness and its tendency to discourage abuse of the payments system.

Operating Costs and the Private Sector Adjustment Factor

I now turn to the issue of whether the Federal Reserve is continuing to subsidize its check clearing operations. As requested by your committee, we analyzed the system the Federal Reserve uses to allocate costs to its check clearing operations. In 1983, the Federal Reserve had an estimated $1.02 billion in total operating expenses. Of this total, the Federal Reserve's Planning and Control System (PACS) allocated about $320 million to check clearing. Part of this amount represents direct expenses; the remainder represents an allocation of support and overhead expenses. We paid particularly close attention to the reasonableness of procedures used to allocate support and overhead expenses because this is an area where judgments come into play. We found that PACS rules were to a large extent reasonable and being conformed with.

However, we identified eight overhead and support accounts as well as expenses for the Board of Governors where there appears to be a basis for reconsidering the allocation rules currently followed. We then considered the effect on prices if a higher percentage of these expenses were allocated to check clearing. Based on our analysis of each category, we selected measures that we believed collectively represented the upper bound of increased allocations that might be justified. As a

result of these reallocations, operating expenses associated with check clearing would increase by about $17 million and prices would rise by roughly 5 percent.

The changes we made to the allocation rules should not be construed as indicating deficiencies in the methods currently being used. Whether current methods are appropriate could only be determined by a detailed examination of how the resources in each category are actually used. Our calculations should simply be viewed as an effort to determine the significance of giving the Federal Reserve no benefit of the doubt in the most questionable allocation rules and seeing what the effect would be on prices. Because the effect is modest, we do not believe that there are glaring expense omissions or understatements that would significantly affect Federal Reserve prices.

The Monetary Control Act requires the Federal Reserve to include in its prices for check clearing an adjustment for the taxes and return on capital that would be incurred by a private firm. Determining what this adjustment should be is a very complex exercise.

In October the Federal Reserve proposed to recover $56 million through the PSAF in 1984. After carefully studying the methodology used by the Federal Reserve, we saw no reason to propose a higher PSAF. The Federal Reserve's measure of the amount of capital allocated to check clearing, the debt/equity ratio used, and the effective tax rates used, and the average pre-tax

return on capital of 17.2 percent all appeared reasonable. In March the Federal Reserve adopted a revised PSAF calculation of about $59 million. The revisions the Federal Reserve made also appear to be reasonable.

Some critics of the Federal Reserve's calculations take issue with all assumptions made and measures used to calculate the PSAF, arguing that it should be over 3 times higher. Because there is not a set of firms exactly like the Federal Reserve, disagreements about judgments made are bound to exist. For this reason we cannot say precisely what the PSAF should be. We do not believe, however, that anything approaching a PSAF that is roughly 3 times higher than that proposed is reasonable.

It is important to note that the way the Federal Reserve calculates its PSAF omits profit that the System makes on its clearing balances. Taking this into account would raise the excess of revenues over costs above the PSAF range that we think is needed. Procedures now being considered by the Federal Reserve may, however, reduce or eliminate the profit on clearing balances.

DISCLOSURE AND GUIDELINES ON COMPETITIVE PRACTICES

The Monetary Control Act placed the Federal Reserve in the unique and difficult position of competing directly in its check clearing and other priced services operations with many of the same institutions that it regulates. The Federal Reserve is,

however, taking some steps that should help reduce the tensions that can easily be generated by its central bank status. We are encouraged by the action that the Federal Reserve is now taking to disclose more fully its financial and program information as well as its efforts to develop policies defining the bounds of its competitive actions. These steps do not, of course, deal with the basic economic concerns of the correspondent banks but they should be helpful in reducing misunderstandings about how the Federal Reserve is carrying out its responsibilities.

Mr. Chairman that concludes my prepared statement. My colleagues and I will be happy to respond to any questions the committee might have.

The CHAIRMAN. Thank you very much, Mr. Anderson.

When the Federal Reserve issued its new rule on noon presentment, the Fed greatly increased its competitive position vis-a-vis the private sector competitors. How can private sector competitors make capital investment decisions such as buying new check processing machines when the Fed can unilaterally change the rules of the game?

GROUND RULES NEED TO BE STABLE

Mr. ANDERSON. To the extent that the Fed in some arbitrary, preemptory manner, abuses the position that it has as the Nation's central bank, there remains no doubt at all that there are risks associated in the private sector in that the ground rules of the game can change.

On the other hand, we believe for that particular change, it has not been conclusively established that it changed the ground rules so significantly as to adversely impact on private banking concerns.

There's also a question about whether the presentment fees that the Federal Reserve doesn't have to pay have any justification in many situations. I understand a bill may even have been written in the Congress somewhere that would prohibit their application across the banking industry. I also understand that although precise data are not available that it's a small minority of some of the major banks that in fact even charge presentment fees. I think there are a lot of unknowns concerning that particular issue, but your basic point is well taken. It's something that the Fed will have to act on as a responsible citizen and the Congress is going to have to exercise close supervision to insure that the Fed's central bank status is not abused.

The CHAIRMAN. The ABA in their statement this morning makes a recommendation that the Fed issue a policy statement indicating its long-term intentions with respect to its share of the market for check clearing services.

Do you agree with the ABA that that type of statement would help private sector competitors make investment decisions?

Mr. ANDERSON. I certainly do, sir.

The CHAIRMAN. What would be the consequences if the Congress were to direct the Federal Reserve to phase out its check clearing operations and let the private sector handle these activities?

Mr. ANDERSON. I think there would be a tremendous period of dislocation there. I would say that a lot of the smaller institutions across the country, perhaps especially those in isolated and rural areas, could experience some real difficulties. I would be very apprehensive about a move in that direction based upon what I've been able to learn about the function that the Fed performs. In fact, its national system is in place and essentially we have a number of local markets existing and we would have to establish a whole new mechanism that I just can't see coming easily. I think it's something that could be studied, but it would have to be studied very carefully to gage its impact on the banking system.

The CHAIRMAN. Would you suggest that the Fed could be phased down but still maintain some minimum level of activity to provide service to remote communities?

Mr. ANDERSON. If in fact the Fed is expected to pay for its operations out of the revenues that it obtains for providing them, I'm not sure that what you suggest would be feasible, without recognizing that there would have to be some sort of a Federal subsidy. I see it essentially that the same cream skimming could occur as, for example, would occur if the private express statutes affecting the Postal Service were lifted. There is no doubt about the fact that the revenues beyond costs that the Postal Service achieves for providing services to cities and large metropolitan areas are helping to offset costs for moving the mail out to these other areas. You have to recognize that there has to be an explicit subsidy built into the services.

The CHAIRMAN. In GAO's 1982 study you indicate in your testimony that the Fed was pricing its services too low. In his formal statement this morning, the National Payments System Coalition, Mr. Sullivan says that over the past 3 years the Fed has subsidized its prices by more than $500 million. You state in your testimony that they had changed and that this is no longer the case.

He also goes on to say that with this subsidy the Fed has diminished the viability of private firms in this business.

Mr. ANDERSON. I guess I would say that the subsidy appears to have been finally eliminated in 1984, particularly as the result of the last 7-percent price increase that occurred in December 1983. There were definitely subsidies up through 1983. I would have to see exactly how the National Coalition arrived at that estimate in order to comment on it intelligently. But our recent report certainly provides the basis for our own evaluation of the current situation in great detail.

The CHAIRMAN. Senator Hecht.

Senator HECHT. No questions, Mr. Chairman.

The CHAIRMAN. Mr. Anderson I have no additional questions. We appreciate all the work that's been put into this study and your willingness to testify today.

Mr. ANDERSON. Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you very much.

The next witness is Mr. Barry Sullivan, chairman and chief executive officer of the First National Bank of Chicago; on behalf of the National Payments System Coalition. While Mr. Sullivan is coming up, I would say that Congressman Barnard hoped to be here at the hearing this morning to testify and he's not able to be here, but he will be sending a statement for inclusion in the record, which we will be happy to do.

[Statement of Congressman Barnard follows:]

Statement of Rep. Doug Barnard, Jr., Chairman
House Subcommittee on Commerce, Consumer, and Monetary Affairs
on
Federal Reserve Pricing of Payments System Services
before the
Senate Committee on Banking, Housing, and Urban Affairs
April 11, 1984

It is very timely and appropriate that this committee is considering today the Federal Reserve's administration of its responsibilities under the Monetary Control Act of 1980, and I am delighted to have the opportunity to share with my colleagues in the other chamber some personal impressions on this subject.

Section 107 of the Monetary Control Act represented an important banking milestone in two important respects, in my judgment. By requiring the Fed to charge full-cost fees for the check processing and other payments system services that it had previously given free to member institutions, the MCA provided an important stimulus to efficiency and economic rationality in banking, and it initiated a unique experiment in public sector vs. private sector competition. I might add that it also reduced the federal budget deficit by several hundred million dollars annually.

Since then, of course, a considerable debate has emerged over whether it is desirable to continue the operational role of the Fed in payments services. The suggestion has been made that perhaps we should instead terminate the public vs. private competition established by the MCA by placing the Fed's priced services operations in a separate corporation that would be subject to private sector capital costs and taxation and normal business risks.

This debate has two main themes, the first of which is the fairness theme. Serious questions have been raised about whether the Fed has been competing fairly, and some have suggested that fair competition with the Fed may not be possible, given the unique and privileged status of the Fed as both the regulator and the dominant provider of services.

The second theme has been the public necessity theme. The Fed's critics have suggested that, regardless of whether the competition is fair or not, there is no public purpose served by the Fed's retaining a major operational role. This line of argument leads to the conclusion that payments processing should be left exclusively to the private sector, in observance of the principle that the government should not be mixed up in activities that the private sector can handle adequately.

Last June the Commerce, Consumer, and Monetary Affairs Subcommittee, which I chair, looked into these matters in joint hearings with Mr. Fauntroy's monetary policy subcommittee, and subsequently we have prepared a comprehensive report on the issues raised at the hearings. The Government Operations Committee approved this report yesterday, and it will be printed shortly.

Without going into technical details, I would like to share with you the general tenor of our findings, which is the following:

1. The Fed's competitors have had a valid basis for raising questions about some of the Fed's pricing decisions and the special advantages it enjoys, but these problems are correctable within the present framework; and

2. The Fed's continuing operational presence is important for ensuring the complete reliability and safety of the payments system, and consequently removing the Fed from its active role would not be a wise policy.

Public Necessity and the Fed

Before discussing fairness, I want to take up the second of these, the necessity for the Fed to retain an active operational role. The need for a continuing Fed role is dictated, I believe, by the absolutely essential requirement of complete reliability and safety for the system of payments processing. We can not afford the risk of financial disruption that could arise, assuming the Fed were removed from payments

processing, if the private correspondents refused to handle items drawn against other institutions whose solvency was rumored to be in doubt.

The Fed, as a quasi-public entity, serves all depository institutions and accepts all checks and other payments items for collection without regard to the financial condition of the institutions from whom they must ultimately collect the funds. This provides an assurance of stability to the financial system that can not be duplicated by the private correspondent banks alone.

The Fed's continuing presence in payments processing is also needed as a totally reliable alternative whose solvency is never in doubt. Whenever any financial institution sends checks to a private correspondent for collection, it is making an uninsured deposit in the correspondent institution to the extent that its items add up to more than $100,000. Any concern, whether reasonable or totally groundless, about the solvency of one or more correspondent institutions, could be very disruptive of the payments system if the institutions needing check collection services did not have an assured and riskless alternative, namely the Fed, to turn to.

For these reasons, I believe that the Fed needs to remain in payments processing, even though the private sector undoubtedly has the technical and managerial capabilities to handle the task under normal circumstances. Appealing as it may seem in some abstract sense to turn the job entirely over to the private sector, perhaps by placing the Fed's present payments operations in an autonomous corporation, I believe that this would be an unwise policy.

The only qualification I would offer to this general observation about the role of the Fed is that there appears to be no essential public service need for the Fed to retain as large a scale of operations as it presently maintains. The Fed currently handles a very substantial percentage of all payments that require intercity collection, but its check processing operations do not exhibit economies of scale in general, and may even be subject to measurable diseconomies of scale in certain large operations centers.

Consequently, it appears that the Fed's essential public service obligations could continue to be met efficiently even if its scale of operations were curtailed.

I do not in fact advocate curtailment, because as long as the Fed's operating efficiency continues to match or exceed that of the private sector, then it is entirely reasonable for them to continue operating at the present scale. The point is merely that the public service responsibilities of the Fed, which clearly justify a Fed operational presence, do not by themselves inherently justify the present scale of operations.

Fair Competition and the Fed

I am sure I do not need to elaborate on the merits of competition generally. The power of competition to stir people and organizations to efficient performance and creative innnovation is a basic tenet of our system, and it is one reason that we have always tended to look with disfavor on the idea of the government engaging in commercial activities that the private sector can handle.

If in spite of this the government HAS to be involved in commercial activities, as I have indicated I believe it must in the present situation of payments services, then it is very important to maintain an atmosphere of active private competition as well. The Fed has no monopoly on efficiency and innovation. In fact, some of the Fed operations were quite inefficient prior to 1980 and have improved their efficiency dramatically since pricing began, which only demonstrates the point. Competition is just as necessary for keeping the Fed on its toes as for ensuring private sector efficiency.

For this reason it is important that Congress give serious attention to the issues raised by the Fed's competitors. To the extent that certain inherent advantages enjoyed by the Fed or certain Fed pricing policies may inhibit private competition or make it difficult for private competitors to continue their operations, then Congress needs to give careful attention to this issue, in order to ensure the continued efficiency as well as reliability and safety of our system of financial transactions.

It appeared to me from our hearings that the Fed's competitors raised some valid points of criticism about how the competition with the Fed is working out and how the Fed is setting its prices. In particular, the Fed's freedom to accept deposit of checks across state lines and without regard for the branch banking restrictions that limit the geographical range of their competitors seems to be an unfair competitive disparity, and I have introduced legislation to correct this imbalance.

In addition, considerable controversy has developed about the Fed's statutory exemption from presentment fees and their methodology for determining the allowance for the imputed costs of capital and taxes - the private sector adjustment factor or PSAF - that is added to their other costs in setting prices. I think the Fed's competitors have raised valid questions on these subjects that are related to the fairness of the present competition.

I have also had some concern about whether there may be an unfair interdistrict subsidy built into the Fed's prices, such that the prices the Fed charges in some districts may be below their true costs while the prices in other districts may be correspondingly above cost.

My point today, however, is not to elaborate on these specific issues - which are addressed in detail in our forthcoming committee report - but to offer the view that the whole matter of fair competition in payments services can easily be clarified and resolved by an appropriate Congressional directive to the Fed.

My point is really twofold. First, I don't believe that Congress conveyed to the Fed a clear message on the matter of fair competition in the 1980 act, and second, I am confident that if such a message is conveyed, the Fed will fulfill the Congressional directive faithfully.

The legislative history of the pricing provision of the Monetary Control Act shows Congressional concern over whether private suppliers of services would continue to have a fair opportunity to compete for business against the Fed, and Fed chairman G. William

Miller assured the House Banking Committee, during 1978 hearings on bills that would have established Fed pricing on almost the same terms as were finally adopted in 1980, that the Fed would not undercut the private sector.[1] Congress did not, however, put anything explicit into the Monetary Control Act about fair competition with the private sector, and this omission is subject to the possible interpretation that Congress may not place great importance on this objective.

It can be argued, of course, that the Act's requirement of full cost recovery, including recovery of indirect, overhead, and imputed costs, should also have the effect of ensuring fair competition, but in the Government Operations Committee we reached the contrary conclusion that full cost recovery does not by itself ensure fair competition. This finding arises in part from the observation that full cost recovery in the aggregate can hide interdistrict subsidies and subsidies to individual components of the service line that could give rise to unfair competition against certain specific competitors. Furthermore, there is room for the Fed to exercise substantial discretion in determining how it will estimate its indirect and imputed costs, and it is reasonable to hold its decisions on accounting methodology up to the test of fairness. In particular, the adoption of controversial accounting conventions that favor lower prices for Fed services can reasonably be questioned on grounds of competitive fairness. For these reasons, we concluded that the present statutory language on Fed pricing is not sufficiently clear on the matter of competitive fairness.

On the other hand, our thorough review of the Fed's pricing and operational decisions since enactment of the Monetary Control Act has not found any deliberate

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1 See Raymond Natter, "Legislative Intent Regarding Pricing of Services by the Federal Reserve Board," Congressional Research Service, Library of Congress, January 25, 1984.

effort by the Fed to undercut the private sector. On the contrary, I feel confident that the Fed, if so instructed by Congress, would carry out conscientiously and effectively any requirement to make sure that its policies provide a full opportunity for fair competition.

As public agencies go, the Fed is one of our best. Their integrity and commitment to serving the public interest, as spelled out by Congress where necessary, is exemplary. I think the issues of fair competition that have recently arisen - significant and valid issues, as I have already observed - are no more than the normal consequence of the difficulties the Fed has faced in making a major transition to its present competitive mode of operation, coupled with a lack of clear direction from Congress.

What I believe is needed, therefore, and what our forthcoming committee report recommends, is a legislative amendment to make fair competition with the private sector an explicit objective of Fed policy in the priced services area. This would be in addition to the objective of full cost recovery that is already specified there. With this step, plus the related step of providing for interstate pick-up of checks, I believe that Congress can effectively respond to the concerns that have been expressed by the banks about fair competition with the Fed.

The CHAIRMAN. Mr. Sullivan, we are happy to have you before us this morning. Please go ahead.

STATEMENT OF BARRY SULLIVAN, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, FIRST NATIONAL BANK OF CHICAGO; ON BEHALF OF THE NATIONAL PAYMENTS SYSTEM COALITION

Mr. SULLIVAN. Thank you, Senator. I'm happy to be here.
[The complete statement follows:]

MY NAME IS BARRY F. SULLIVAN. I AM CHAIRMAN OF THE BOARD OF THE FIRST NATIONAL BANK OF CHICAGO. THIS MORNING, I APPEAR BEFORE YOU TO PRESENT TESTIMONY ON BEHALF ON THE NATIONAL PAYMENTS SYSTEM COALITION.

THE COALITION IS AN AD HOC AFFILIATION OF SOME FIFTY BANKS AND COURIER COMPANIES WHICH OFFER TRANSPORTATION, CLEARING, PROCESSING, WIRE TRANSFER, AND OTHER SERVICES ASSOCIATED WITH OUR NATION'S PAYMENT MECHANISMS.

THE COALITION APPRECIATES THE OPPORTUNITY TO PARTICIPATE IN THIS LEGISLATIVE OVERSIGHT HEARING TO REVIEW OPERATING EXPERIENCE UNDER SECTION 7 OF THE MONETARY CONTROL ACT OF 1980. AS YOU RECALL, THAT ACT DIRECTED THE FEDERAL RESERVE TO PRICE PAYMENTS AND OTHER SERVICES THAT IT OFFERS TO DEPOSITORY INSTITUTIONS, INCLUDING BANKS.

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WITH THE IMPLEMENTATION OF THE MONETARY CONTROL ACT'S PRICING MANDATE, THE INSTITUTIONS THAT ARE PART OF THE COALITION HAVE COME INTO DIRECT COMPETITION WITH THE FEDERAL RESERVE'S SERVICE ACTIVITIES. NOW, THE MEMBERS OF THE COALITION COMPETE VIGOROUSLY WITH EACH OTHER AND ACCEPT THESE COMPETITIVE CHALLENGES. BUT, COMPETITION WITH THE FEDERAL RESERVE IS PROVING TO BE VERY DIFFICULT, BECAUSE THE FED ENJOYS SEVERAL UNIQUE ADVANTAGES OVER ITS PRIVATE SECTOR COMPETITORS.

WE NOW HAVE NEARLY THREE YEARS OF EXPERIENCE WITH THE MARKET EFFECTS OF SECTION 7'S POLICY DIRECTIVES, AND THE NATURE OF THAT EXPERIENCE CAUSES US TO BELIEVE THAT THERE IS A CRITICAL NEED FOR THE CONGRESS TO FORMALLY DEFINE THE APPROPRIATE ROLE OF THE FEDERAL RESERVE IN THE NATIONAL PAYMENTS SYSTEM. WE BELIEVE THAT THE OBJECTIVE SHOULD BE TO ESTABLISH A PUBLIC POLICY FRAMEWORK CAPABLE OF ENSURING THAT OUR NATIONAL ECONOMY WILL BE SERVED BY THE MOST MODERN, MOST EFFICIENT, AND SAFEST SET OF PAYMENTS SERVICES ACHIEVABLE.

THE BEST ASSURANCE FOR SUCH A SYSTEM IS PROVIDED BY A PAYMENTS SERVICES MARKET IN WHICH THERE IS FAIR AND VIGOROUS COMPETITION AMONG NUMEROUS PARTICIPANTS. A MARKET IN WHICH A MAJORITY OF THE PAYMENTS SERVICES IS PROVIDED BY COMPETITIVE PRIVATE FIRMS OFFERS THE GREATEST PROBABILITY THAT ECONOMIC RESOURCES WILL BE EFFICIENTLY ALLOCATED. I WILL HAVE MORE TO SAY ABOUT THE NATURE OF THAT MAJORITY AT THE CONCLUSION OF MY TESTIMONY.

WHEN THE CONGRESS PASSED THE MONETARY CONTROL ACT IN 1980, IT WAS CONCERNED SOLELY WITH THE ACTIONS THAT NEEDED TO BE TAKEN TO ENHANCE THE FEDERAL RESERVE'S ABILITY TO EFFECTIVELY IMPLEMENT MONETARY POLICY. GIVEN THE IMPORTANCE OF MONETARY POLICY, IT IS NOT SURPRISING THAT LITTLE ATTENTION WAS GIVEN TO DEVELOPING AN UPDATED DEFINITION OF THE FEDERAL RESERVE'S ROLE IN PROVIDING PAYMENTS SERVICES.

BUT IT IS NOW ESSENTIAL THAT THIS BE DONE.

WITHOUT SOME FUNDAMENTAL ADJUSTMENTS IN THE FEDERAL RESERVE'S ACTIVITIES AS A PAYMENTS SERVICES VENDOR, THE OUTLOOK FOR BANKS AND OTHER PRIVATE FIRMS AS PROVIDERS OF PAYMENTS SERVICES IS LESS THAN ENCOURAGING. OF COURSE, THE VIABILITY OF ANY PARTICULAR FIRM OR CLASS OF FIRMS IS NOT THE NECESSARY FOCUS OF CONGRESSIONAL CONCERN. BUT IT IS A FACT THAT THE VIABILITY OF THE PRIVATE SECTOR AS A WHOLE CREATES THE CAPACITY FOR INDIVIDUAL FIRMS TO INVEST IN PAYMENTS SERVICES AND TO REMAIN AS PARTICIPANTS IN THAT BUSINESS. THEREFORE, IF THE PAYMENTS SERVICES MARKET IS NOT TO BE MONOPOLIZED BY THE NATION'S CENTRAL BANK, THE CONGRESS MUST TAKE APPROPRIATE ACTION NOW.

I MIGHT POINT OUT THAT OUR CALL FOR A FUNDAMENTAL REVIEW OF THE FED'S OPERATING ROLE IN THE PAYMENTS AREA REPRESENTS A MAJOR SHIFT IN THE COALITION'S VIEWPOINT OVER THE PAST FEW MONTHS. ORIGINALLY, THE COALITION BELIEVED THAT SOME REFINEMENT IN THE PROVISIONS OF THE MONETARY CONTROL ACT COULD TRANSFORM THE FED INTO A MORE CONVENTIONAL COMPETITOR. BUT SUBSEQUENT EXPERIENCE AND FURTHER ANALYSIS HAVE LED US TO THE CONCLUSION THAT ADJUSTMENTS IN THE ACT PROBABLY CANNOT CAUSE THE FED TO BECOME "JUST ANOTHER COMPETITOR."

THIS IS SO BECAUSE OF SEVERAL FACTORS: THE FED'S DOMINANT MARKET SHARE (50 PERCENT OF THIRD-PARTY CHECK SERVICES, 80 PERCENT OF DOMESTIC WIRE TRANSFER, AND 90 PERCENT OF AUTOMATED CLEARINGHOUSE VOLUME); ITS CONFLICTING ROLES AS RULE MAKER AND SERVICE VENDOR; ITS UNIQUE NATIONWIDE NETWORK; AND ITS LEGAL AND STRUCTURAL IMMUNITY FROM BEARING SIGNIFICANT COSTS OF DOING BUSINESS.

LET ME CITE JUST A FEW BRIEF EXAMPLES WHICH DEMONSTRATE THAT THE FED IS NOT "JUST ANOTHER COMPETITOR."

FIRST, THE FEDERAL RESERVE PERFORMS ITS PAYMENTS PROCESSING SERVICES THROUGH AN INTEGRATED NATIONAL NETWORK WHICH INCLUDES 44 PROCESSING CENTERS. NO SINGLE PRIVATE COMPETITOR POSSESSES RESOURCES OF THIS MAGNITUDE, AND BECAUSE OF THE RESTRICTIONS OF FEDERAL AND STATE LAW, NO PRIVATE COMPETITOR CAN MATCH THE GEOGRAPHIC REACH OF THE FEDERAL RESERVE NETWORK. FURTHERMORE, IT IS OUR JUDGMENT THAT THIS INTEGRATED NATIONAL SYSTEM PERMITS A DEGREE OF FLEXIBILITY IN PRICING STRATEGY THAT ALLOWS THE FED TO REALIZE PRICING ADVANTAGES IN PARTICULAR PRODUCT AND GEOGRAPHIC SEGMENTS OF THE MARKET.

SECOND, THERE HAVE BEEN OCCASIONS ON WHICH THE RULE-MAKING FUNCTION OF THE FEDERAL RESERVE HAS SERVED TO BENEFIT THE FED'S COMPETITIVE POSITION AS PROVIDER OF PAYMENT SERVICES. AS RULE MAKER AND NET SETTLER, THE FEDERAL RESERVE GRANTS GUARANTEED SAME-DAY AVAILABILITY FOR ITS WIRE TRANSFER FACILITY, FEDWIRE. BUT THE FED LIMITS THE PRIVATE WIRE TRANSFER SYSTEM, BANKWIRE, TO NEXT-DAY AVAILABILITY. NOT SURPRISINGLY, AS A CONSEQUENCE, FEDWIRE HAS 80 PERCENT OF DOMESTIC WIRE TRANSFER VOLUME.

LIKEWISE, ANOTHER RULE-MAKING ACTION -- NAMELY, DECREEING THAT FEDERAL RESERVE BANKS MAY PRESENT ITEMS FOR PAYMENT AT CITY END POINTS UP UNTIL NOON EACH DAY -- HAS ALSO PROVIDED A SIGNIFICANT MARKET ADVANTAGE FOR THE FED. IN THIS CASE, FLOAT REDUCTION WAS THE INTENDED PURPOSE OF THE RULE. BUT ITS PRACTICAL EFFECT WAS TO PERMIT THE FED TO OFFER A FINANCIAL INCENTIVE (BETTER AVAILABILITY) TO DEPOSITING BANKS. IN CONTRAST, NO PRIVATE FIRM CAN UNILATERALLY OBTAIN THE RIGHT TO PRESENT CHECKS FOR PAYMENT AFTER NORMAL CLEARINGHOUSE HOURS. ANY SUCH LATER PRESENTMENTS BY PRIVATE BANKS MUST BE ARRANGED THROUGH A NEGOTIATED AGREEMENT, WHICH NORMALLY INCLUDES THE PAYMENT OF PRESENTMENT FEES.

UNDER THESE CIRCUMSTANCES, WE ARE CONVINCED THAT THE CONGRESS MUST REEVALUATE THE FEDERAL RESERVE'S PRESENT AND FUTURE ROLE IN THE PAYMENTS SYSTEM. AND SUCH A REEVALUATION MUST BEGIN WITH THE RECOGNITION THAT THE UNITED STATES OF 1984 IS FAR DIFFERENT FROM THE NATION OF 1915, WHEN THE FEDERAL RESERVE UNDERTOOK ITS ROLE IN CHECK CLEARING AND PROCESSING.

IN 1915, CHECK PAYMENT -- THE PRINCIPAL MEDIUM OF MONEY TRANSFER -- WAS SERIOUSLY ENCUMBERED BY THE REFUSAL OF MANY BANKS TO PAY, AT PAR, CHECKS DRAWN ON OUT-OF-TERRITORY BANKS. THIS BUSINESS PRACTICE STEMMED IN LARGE PART FROM THE FACT THAT THE BANKING SYSTEM WAS HIGHLY DECENTRALIZED, HAD SUFFERED SEVERAL EPISODES OF INSTABILITY, AND LACKED RELIABLE UNIVERSAL INFORMATION ON INSTITUTIONAL QUALITY. NON-PAR BANKING FORCED PAYEES (BOTH COMMERCIAL AND INDIVIDUAL) TO TAKE ROUNDABOUT ROUTES TO OBTAIN FULL PAYMENT OF CHECKS. INADEQUATE TRANSPORTATION AND COMMUNICATION FACILITIES COMPOUNDED THE PROBLEM, MAKING FOR AN INEFFICIENT AND UNRELIABLE SYSTEM FOR NEGOTIATING PAYMENTS, EITHER REGIONALLY OR NATIONALLY. THE ECONOMY NEEDED A RELIABLE BRIDGING NETWORK FOR PAYMENTS. THROUGH ITS TWELVE DISTRICT BANKS AND THE NETWORK OF MEMBER BANKS, THE FEDERAL RESERVE OFFERED THAT BRIDGING MECHANISM.

NON-PAR BANKING WAS ESSENTIALLY ELIMINATED FROM OUR BANKING SYSTEM OVER TWENTY YEARS AGO. CHECK CLEARING TODAY IS ACHIEVED THROUGH AUTOMATED PROCESSING, ELECTRONIC READING OF MAGNETIC ENCODING, COMPUTERIZED ROUTING PROCEDURES, AND HIGH-SPEED AIR AND SURFACE TRANSPORTATION.

TODAY, THE FEDERAL RESERVE PERFORMS THREE SEPARATE AND DISCRETE FUNCTIONS IN THE PAYMENTS AREA. FIRST, THE FED, AS REGULATOR, HAS THE RESPONSIBILITY OF SETTING RULES TO ENSURE SAFETY AND EFFICIENCY. SECOND, THE FED PROVIDES NET SETTLEMENT. IN THIS FUNCTION, RESERVE BALANCES ARE UTILIZED FOR THE PAYMENT OF CREDIT AND DEBIT TRANSACTIONS AMONG BANKS. THIRD, THE FED IS A SUPPLIER OF PAYMENTS SERVICES. AND HERE IT COMPETES DIRECTLY WITH THE PRIVATE SECTOR IN WIRE TRANSFERS, CHECK CLEARING, AND THE PROCESSING OF AUTOMATED CLEARINGHOUSE TRANSACTIONS.

WITH RESPECT TO THE REGULATORY FUNCTION, THERE IS NO QUESTION THAT THE FEDERAL RESERVE SHOULD BE THE PRINCIPAL RULE MAKER FOR ALL ACTIVITIES ASSOCIATED WITH THE PAYMENTS MECHANISMS. I WILL HAVE MORE TO SAY ABOUT THIS IN A MOMENT. AT THIS JUNCTURE I WILL ONLY COMMENT THAT THE COALITION BELIEVES THAT THE PRIVATE SECTOR SHOULD HAVE SOME FORMAL REPRESENTATION IN THE RULE-MAKING FUNCTION.

WITH REGARD TO NET SETTLEMENT, THE FED IS AT THIS TIME UNIQUELY POSITIONED TO CARRY OUT THIS FUNCTION. THIS IS BECAUSE A KEY ELEMENT IN NET SETTLEMENT IS THE CONFIDENCE OF ALL PARTICIPANTS IN THE FINANCIAL STRENGTH AND RELIABILITY OF THE SETTLEMENT INSTITUTION. THERE IS CURRENTLY NO PRIVATE INSTITUTION THAT CAN MATCH THE FED IN THIS REGARD.

THE FED'S ROLE IN THE PROCESSING AND SERVICING OF PAYMENTS TRANSACTIONS IS VERY MUCH IN NEED OF CAREFUL REEXAMINATION.

THIS IS SO BECAUSE THERE ARE NO PAYMENT TRANSACTION SERVICES THAT ARE BEYOND THE PHYSICAL AND FINANCIAL CAPABILITIES OF THE NATION'S DEPOSITORY INSTITUTIONS. MOREOVER, AS CROSS-ENTRY PROCEEDS WITHIN THE FINANCIAL SERVICES BUSINESS, A NUMBER OF INSURANCE, SECURITIES, RETAIL AND CONSUMER FINANCE FIRMS ALSO HAVE THE RESOURCES TO BECOME MAJOR COMPETITORS IN THE PAYMENTS PROCESSING BUSINESS -- PROVIDING, OF COURSE, THERE EXIST MARKET OPPORTUNITIES JUSTIFYING INVESTMENT BY PRIVATE FIRMS.

GIVEN THE WIDE ARRAY OF CAPABLE PRIVATE SECTOR SUPPLIERS, UNLESS THERE ARE COMPELLING REASONS FOR A GOVERNMENT OPERATING PRESENCE, PUBLIC POLICY SHOULD ENCOURAGE THE PARTICIPATION OF THE PRIVATE SECTOR. AS YOU RECALL, THE PROPOSED "FREEDOM FROM GOVERNMENT COMPETITION ACT" (S.1746) STATES THAT "COMPETITIVE PRIVATE ENTERPRISES ARE THE MOST PRODUCTIVE, EFFICIENT AND EFFECTIVE SOURCE OF GOODS AND SERVICES," AND THAT GOVERNMENT COMPETITION SHOULD BE LIMITED WHEREVER POSSIBLE.

AND THIS CAN BE DONE AT THE SAME TIME THAT VITAL PUBLIC POLICY INTERESTS ARE SERVED. FOR EXAMPLE, THERE IS A SIGNIFICANT NATIONAL INTEREST IN ASSURING THAT SECURITIES TRANSACTIONS ARE PROCESSED EFFICIENTLY, FAIRLY, AND SAFELY. TO ASSURE THAT THIS LEGITIMATE NATIONAL INTEREST IS PROTECTED, THE SECURITIES AND EXCHANGE COMMISSION (SEC) HAS BEEN CHARGED WITH REGULATING AND SUPERVISING EXCHANGES THAT PROCESS SECURITIES TRANSACTIONS. BUT IT HAS NEVER BEEN SERIOUSLY ARGUED THAT IN ORDER TO SECURE THESE PUBLIC POLICY GOALS, THE SEC SHOULD HAVE AN OPERATING PRESENCE IN THE NATION'S SECURITIES MARKETS.

IN CONTRAST, HOWEVER, THE FEDERAL RESERVE IS THE DOMINANT PROVIDER OF PAYMENTS SERVICES.

ONE OF THE REASONS WHY THE FED HAS ACHIEVED THIS DOMINANCE IS THAT ITS EXEMPTION FROM PAYING PRESENTMENT FEES CONFERS ON THE FED A SUBSTANTIAL COMPETITIVE COST ADVANTAGE. A PRESENTMENT FEE IS AN ITEM CHARGE PAID TO THE PAYOR BANK, TYPICALLY FOR THE ABILITY TO DEPOSIT CHECKS OTHER THAN THROUGH A CLEARINGHOUSE.

A RECENTLY PREPARED DRAFT REPORT FROM THE GENERAL ACCOUNTING OFFICE -- ON A STUDY CONDUCTED AT THE REQUEST OF MEMBERS OF THIS COMMITTEE -- COMMENTS THAT THE FED'S EXEMPTION FROM PRESENTMENT FEES DOES, IN FACT, CONSTITUTE A SIGNIFICANT COST ADVANTAGE. A CONSULTANT'S STUDY PREPARED JUST LAST YEAR FOR THE NATIONAL PAYMENTS SYSTEM COALITION FOUND, IN A SURVEY OF 18 COMMERCIAL BANKS THROUGHOUT THE UNITED STATES, THAT FULLY 36 PERCENT OF THE COST OF CLEARING AN OUT-OF-DISTRICT ITEM IS THE PRESENTMENT FEE. SO, CLEARLY, THE FED HAS A MAJOR STRUCTURAL ADVANTAGE IN THIS REGARD OVER PRIVATE SECTOR PROVIDERS OF PAYMENTS SERVICES.

AND THE WAY THE FED HAS IMPLEMENTED THE PRICING MANDATE OF THE MONETARY CONTROL ACT HAS ALSO SERVED TO REINFORCE ITS DOMINANT POSITION. AT THE SAME TIME THAT IT HAS BEEN MOUNTING AN AGGRESSIVE MARKETING CAMPAIGN FOR NEW BUSINESS, THE FEDERAL RESERVE HAS BEEN REMARKABLY DELIBERATE IN ADJUSTING PRICES TO FULLY RECOVER ALL DIRECT AND INDIRECT COSTS, INCLUDING FLOAT.

THE PRACTICAL EFFECT OF THESE ACTIONS HAS BEEN THAT THE FED -- THE DOMINANT VENDOR, WITH A MARKET SHARE EXCEEDING THAT OF ANY COMPETITOR BY AT LEAST 25 TO 1 -- HAS SUBSIDIZED ITS MARKET PENETRATION EFFORTS BY MORE THAN HALF A BILLION DOLLARS OVER THE PAST THREE YEARS. THROUGH THIS SUBSIDIZED MARKETING CAMPAIGN, THE FED HAS DIMINISHED THE VIABILITY OF PRIVATE FIRMS IN THIS BUSINESS. MORE IMPORTANTLY, THESE ACTIONS RAISE TROUBLING QUESTIONS ABOUT THE FED'S LONG-RANGE OBJECTIVES. THIS CREATES UNCERTAINTY THAT SERIOUSLY IMPAIRS EFFECTIVE INVESTMENT DECISION MAKING BY PRIVATE COMPETITORS.

AND THIS IS OF CRUCIAL SIGNIFICANCE, BECAUSE TO REMAIN IN THE PAYMENTS SERVICES MARKET, PRIVATE FIRMS MUST MAKE COMMITMENTS TO CONTINUOUS AND SIGNIFICANT INVESTMENTS IN NEW TECHNOLOGY. IN THE TRANSACTION PROCESSING BUSINESS, TECHNOLOGICAL OBSOLESCENCE APPEARS TO BE OCCURRING ON AN EVER SHORTENING TIME CYCLE. IN FACT, MANY EXPERTS ARE FORECASTING AN OBSOLESCENCE RATE IN TECHNOLOGY WITH NO NATURAL BARRIERS FOR AT LEAST THE NEXT TEN YEARS. EMERGING DEVELOPMENTS IN THE FIELD OF TELECOMMUNICATIONS FURTHER COMPLICATE INVESTMENT DECISIONS FOR COMPANIES ENGAGED IN THE TRANSMITTING AND PROCESSING OF FINANCIAL TRANSACTIONS, AS WELL AS THE PROVISION OF ASSOCIATED INFORMATION PRODUCTS FOR CORPORATE AND INDIVIDUAL CASH MANAGEMENT.

THIS COMMITTEE KNOWS ALL TOO WELL FROM ITS EXTENSIVE PUBLIC HEARINGS THAT FUNDAMENTAL CHANGES ARE WELL UNDER WAY WITHIN THE ENTIRE FINANCIAL SERVICES BUSINESS SECTOR. IN SUCH A BUSINESS ENVIRONMENT, FIRMS NEED TO BE UNUSUALLY CAREFUL THAT THEY COMMIT THEIR SCARCE RESOURCES ONLY TO THOSE INVESTMENT OBJECTIVES WITH GOOD PROSPECTS FOR SUCCESS OVER THE LONG TERM.

IN THE AREA OF FINANCIAL TRANSACTION SERVICES, WE ARE RAPIDLY APPROACHING THE POINT WHERE INVESTMENTS MUST BE INCREASINGLY GEARED TO A SHIFT FROM PAPER-BASED TO ELECTRONIC SYSTEMS. THIS TRANSITION WILL BE COSTLY. AND, FURTHERMORE, MANY ELECTRONIC PAYMENTS PRODUCTS WILL BE UNPROFITABLE FOR SOME TIME TO COME. OUR INVESTMENT DECISIONS ARE MADE EVEN MORE DIFFICULT BECAUSE THESE TRANSITIONAL COSTS MUST BE LARGELY FINANCED ON A PAY-AS-YOU-GO BASIS. THE IMPLICATION OF THIS IS THAT OVERALL PROFITABILITY IN OUR EXISTING PAYMENTS BUSINESS MUST BE ADEQUATE AND SUFFICIENT TO FINANCE THE TRANSITIONAL COSTS TO MORE MODERN SYSTEMS.

LARGELY BECAUSE OF THE UNCERTAINTY CREATED BY THE UNDEFINED DIRECTION OF THE FEDERAL RESERVE'S INVOLVEMENT AS A MARKET PARTICIPANT, PRIVATE FIRMS HAVE NO ASSURANCE THAT CURRENT PROFITABILITY WILL, IN FACT, BE ADEQUATE TO PROVIDE VIABILITY FOR THE FUTURE. PRIOR TO THE ACT WE HAD, AS AN INDUSTRY, WORKED WITH THE FEDERAL RESERVE TO RESOLVE THE ISSUES AND RAISE THE EFFICIENCY OF PAYMENT SERVICES. THE FED'S DOMINANT COMPETITIVE PRESENCE, HOWEVER, HAS CREATED AN ENVIRONMENT THAT IS TO SOME EXTENT ADVERSARIAL. AND THAT BENEFITS NEITHER THE PARTICIPANTS NOR THE USERS OF PAYMENTS SERVICES.

THEREFORE, THE COALITION BELIEVES THAT IF THE CONGRESS DESIRES NATIONAL PAYMENTS SERVICES TO CONTINUE TO DEVELOP AND IMPROVE THROUGH THE COMPETITIVE INTERPLAY OF MANY PROVIDERS, IT IS EXTREMELY IMPORTANT THAT THE CONGRESS DEFINE AN APPROPRIATE ROLE FOR THE NATION'S CENTRAL BANK.

TO THAT END, THE COALITION WOULD LIKE TO PROPOSE SOME ACTIONS THAT THE CONGRESS COULD TAKE.

FIRST, THE COALITION BELIEVES THAT THE CONGRESS COULD EXPLICITLY AND EMPHATICALLY STATE THAT IT DESIRES THE PAYMENTS SERVICES MARKETPLACE TO CONTAIN BOTH PRIVATE AND PUBLIC SECTOR PROVIDERS. MORE SPECIFICALLY, THE CONGRESS MIGHT CALL FOR THE FEDERAL RESERVE, IN THE SHORT RUN, TO HAVE NO MORE THAN 50 PERCENT OF THE MARKET FOR ANY CORE PAYMENT SERVICE. THIS "FIFTY-FIFTY" ARRANGEMENT APPEARS TO THE COALITION TO BE APPROPRIATE, BECAUSE IT WOULD ENSURE THAT PAYMENTS SERVICES WOULD REMAIN COMPETITIVE AND EFFICIENT.

IN ADDITION, THE CONGRESS COULD CALL FOR THE FEDERAL RESERVE TO GRADUALLY REDUCE ITS DOMINANT OPERATING PRESENCE IN THE PROVISION OF PAYMENTS SERVICES. AN APPROPRIATE GOAL MIGHT BE NO MORE THAN 40 PERCENT OF THE MARKET FOR ANY CORE PAYMENT SERVICE BY THE YEAR 1990 AND A TARGET OF 25 PERCENT BY THE YEAR 2000. THIS WOULD PERMIT THE FEDERAL RESERVE TO CONTINUE TO MAINTAIN A SIGNIFICANT OPERATING PRESENCE IN PAYMENTS SERVICES BUT GRADUALLY REDUCE ITS ROLE TO A MORE BALANCED RELATIONSHIP WITH PRIVATE SECTOR FIRMS.

A SECOND STEP THAT THE CONGRESS COULD TAKE WOULD BE TO REQUIRE THE FEDERAL RESERVE TO CREATE AN ADMINISTRATIVE RULE-MAKING BOARD THAT WOULD HAVE PRIVATE SECTOR REPRESENTATION. THE NEED FOR SUCH A BOARD STEMS FROM THE CONFLICT OF INTEREST THAT IS INHERENT IN THE FED'S ROLES OF PAYMENTS SERVICES PROVIDER AND REGULATOR. LET ME SAY QUITE CLEARLY THAT THE PROBLEM OF CONFLICT OF INTEREST IN THIS CONTEXT IS A SUBTLE BUT SIGNIFICANT ONE. EVEN THOUGH IT MAY HAVE NO INTENT TO WRITE RULES THAT DISADVANTAGE THE PRIVATE SECTOR, THE FED CANNOT HELP BUT SEE ITS REGULATORY FUNCTION THROUGH LENSES AT LEAST PARTIALLY TINTED BY ITS OPERATIONAL ROLE.

WHILE THE ADMINISTRATIVE RULE-MAKING BOARD THAT WE VISUALIZE WOULD DRAW THE MAJORITY OF ITS MEMBERS FROM THE FED, PRIVATE SECTOR MEMBERS WOULD PLAY AN ACTIVE AND CONSTRUCTIVE ROLE IN THE REGULATORY FUNCTION. I MIGHT ALSO NOTE THAT THIS BOARD, WITH OVERSIGHT BY THE CONGRESS, COULD INSURE THAT THE "FIFTY-FIFTY," 40 PERCENT, AND 25 PERCENT MANDATES WERE BEING OBSERVED.

A THIRD ACTION THAT THE CONGRESS COULD TAKE WOULD BE TO REQUIRE THE FEDERAL RESERVE TO FILE A FIVE YEAR INVESTMENT PLAN THAT WOULD BE UPDATED EVERY YEAR. THIS DOCUMENT WOULD BE AVAILABLE TO PRIVATE SECTOR INSTITUTIONS. AND IT WOULD CLEARLY, SPECIFICALLY, AND QUANTITATIVELY IDENTIFY THE FED'S PAYMENTS SERVICES PLANS FOR THE UPCOMING FIVE YEAR PERIOD.

INCLUDED IN INFORMATION CONTAINED IN THAT REPORT WOULD BE THE FED'S PLANS FOR CAPITAL INVESTMENT IN HARDWARE. IT WOULD ALSO SPELL OUT THE SOFTWARE INVESTMENTS THAT THE FED INTENDED TO MAKE. AND IT WOULD INDICATE THE PRODUCT DEVELOPMENT AND PRODUCT INTRODUCTION SCHEDULE FOR THAT FIVE YEAR PERIOD. BEYOND THAT, THIS REPORT WOULD INDICATE WHAT PROCESSING CAPABILITIES -- IN TERMS OF VOLUME AND TYPE -- THE FED INTENDED TO SUPPORT.

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THE REASON FOR CALLING FOR THE PUBLIC AVAILABILITY OF SUCH A FIVE YEAR PLAN WOULD BE TO REMOVE A MAJOR STRATEGIC PLANNING UNCERTAINTY THAT PRIVATE SECTOR PAYMENT SERVICES PROVIDERS CURRENTLY FACE. AS I NOTED EARLIER IN MY TESTIMONY, PRIVATE SECTOR PAYMENTS SERVICES PROVIDERS MUST UNDERTAKE MAJOR INVESTMENTS ON A CONTINUING BASIS IF THEY ARE TO REMAIN COMPETITIVE. THE PROCESS OF INVESTING INHERENTLY INVOLVES UNAVOIDABLE RISK AND UNCERTAINTY. BUT THE UNCERTAINTY ASSOCIATED WITH A LACK OF KNOWLEDGE OF THE INTENTIONS OF THE FED CAN, AND SHOULD, BE ELIMINATED.

THE REQUIREMENT THAT THE FED MAKE KNOWN ITS FIVE YEAR INTENTIONS WOULD IMPROVE THE EFFICIENCY WITH WHICH PRIVATE SECTOR PROVIDERS ALLOCATE THEIR SCARCE INVESTMENT DOLLARS. AND THAT WOULD BE TO THE BENEFIT OF THE USERS AND THE PROVIDERS OF PAYMENTS SERVICES.

PAYMENTS SERVICES PLAY A VITAL ROLE IN THE FUNCTIONING OF OUR ECONOMY. AND THE PUBLIC AND PRIVATE SECTORS HAVE NECESSARY AND APPROPRIATE ROLES TO PLAY IN PROVIDING THOSE SERVICES. THE MEMBERS OF THE NATIONAL PAYMENT COALITION STAND READY TO PLAY THEIR PART IN PROVIDING SERVICES WHICH ARE EVEN SAFER AND MORE EFFICIENT. WE LOOK TO THE CONGRESS, HOWEVER, TO CREATE THE "LEVEL PLAYING FIELD" THAT WOULD BE TO THE LONG-TERM BENEFIT OF PAYMENTS SERVICES USERS AND SUPPLIERS ALIKE.

THANK YOU.

The CHAIRMAN. Thank you, Mr. Sullivan.

The coalition is urging Congress to define a modern role for the Federal Reserve in our Nation's payments system. In general, what does the coalition believe that role should be?

THE THREE-PART ROLE OF THE FEDERAL RESERVE

Mr. SULLIVAN. I think we see a three-part role. First, we do believe, and as I stated in my testimony, that the Federal Reserve should be the principal rulemaker and supervisor of the system to insure that it functions safely and efficiently.

Second, we believe that the Federal Reserve should also perform the major net settlement function between various segments of the payments system. There is no other option in the economy today, nor in my view will there be an option in the long-term future. That is a very solid, long-run role.

Third, we believe in effect that a deliberate effort should be made to reduce the Fed's dominance over the various payments processing services. We are not recommending that the Federal Reserve get out of the payments business. We did have some thoughts in that direction. I talked about that in the past, but I think the real world says that the Fed is the major, major dominant player today and there's no practical way that it can get out of the business. Therefore, we think that it should be very conscious of its dominance and it ought to have a downward tilt appropriately over time to bring that dominance into a better balance with the private sector providers.

The CHAIRMAN. You suggested that the unusual competitive presence of the Fed may very well cause most private firms to ultimately withdraw from the market.

Do you have any reliable evidence that's currently available to document that concern?

Mr. SULLIVAN. I guess the answer is no and yes. There really isn't a very good comprehensive data base in this area. The GAO's report, which you saw, I think had two significant but not overwhelming items in it. In the second quarter of 1983, the quarter in which the Fed's noon presentment ruling went into effect, during that quarter the Fed increased its volume of interterritory check processing by some 16 percent. It's that interterritory check processing that's most important for the private sector.

Also, the report indicated that the Federal Reserve had increased its client base by some 9 percent. I can tell you that anyone of us in the private sector would be happy with that kind of increase in clients.

But the other two items I would add, and one is anecdotal, come from talking with a variety of providers of payments services. There clearly is a great deal of hesitancy about investing in the payments area. There is, in fact, a fair amount of discussion about withdrawal.

Last, in our own case, and to give you some sense of what kind of impact this competition has had in the year 1982 in the check processing business, on interterritorial collection of checks, we made $6 million. Last year we made zero. I can tell you that among the major private players, whether they went from $6 million to zero

which I don't know, all had a trending profitability that was very precipitous and it's that situation that causes the concern about where should we go in the future.

The CHAIRMAN. Your testimony makes reference to the conflict between the Fed's role as a rulemaker of our payments system and its role as a servicing participant in the payments system.

Are you suggesting the Fed has abused its role as a rulemaker?

Mr. SULLIVAN. I'll give a flat no to that. They have not abused their role, but I think they have not been as sensitive to their status as a dominant competitor as they might be, and there are occasions in which the effect of what they have done in the rulemaking area has given them an advantage. And that's unsatisfactory because it, first, further tilts the competitive imbalance in their direction and, second, because it tends to create the perception of less than total objectivity on their part. But I do not believe that they have abused their rulemaking function.

The CHAIRMAN. Your testimony suggests that the private sector adjustment factor has not worked. Why is that?

Mr. SULLIVAN. It has not worked for two reasons—make that three reasons. One is sort of thinking back a little bit in the past.

First, the National Payments Coalition actually did think for quite a period of time that by dealing with the private sector adjustment factor, it could begin to bring balance into the imbalance, and I think we have come off that thinking because the private sector adjustment factor has implicit in it the thought that the Federal Reserve is just another competitor, and we can equalize the public competitor with a private competitor. That just isn't true. The Federal Reserve is a uniquely dominant competitor.

Second, the private sector adjustment factor does not take into consideration the unique competitive advantage that the Federal Reserve has, for example, a nationwide network, legislative exemption from presentment fees, for another.

And then a third area is an area that we would call fairness, and I want to be careful on how I use the word fairness. Let me give you an example of the fairness issue where the Federal Reserve is not being unfair and yet it's a fairness issue.

COUPON COLLECTION EXAMPLE

In a particular part of the business, coupon collection, which is entered into by the Fed and the private sector firms like ourselves, the coupons that are attached to bonds and they are collected from the payment agent. The Federal Reserve in collecting those coupons can simply debit the reserve account of the financial institution that is the paying agent. No private sector collector can do this. As a result, when those coupons are presented to that paying agent they are often not paid right on time. As a result, as a private sector firm, we have to put into our price an estimated cost of the float carrying that nonpayment. That instantly debits a reserve account.

That's a competitive disadvantage for us that is not created by any unfairness on the part of the Fed. It is a competitive advantage that's inherent in the nature of the Fed and the PSAF can't take that into consideration.

The CHAIRMAN. According to Federal Reserve figures, the Fed increased its check processing volume by about 2 percent in 1983. At the same time, total check volume increased by about 5 percent. This implies that the Fed is losing market share.

If this is the case, why are you so worried about the competition from the Fed?

Mr. SULLIVAN. I think our figures are close to those. The figure they don't show is it going from $6 million to zero on profitability. What happened is that during that period of time the private sector, in order to remain competitive with a very aggressive Fed, had to do some significant reducing of prices and, as a result, profitability went dramatically south. And my concern about that is that while there are obvious benefits for those who are getting lower prices, I'm worried about the long-run implications for that continuing over any long period of time.

The CHAIRMAN. Well, if the Fed found this did reduce over the years, though, what does that say about the pricing? Are the people then going to be held to the private side?

Mr. SULLIVAN. You're giving me the flip side of the coin, and the answer to that is if we had a clear Federal Reserve goal that was a relatively modest declining tilt, I don't have any doubt that that will encourage investment by present players in the game and will add more players to the game. So that the concern of whether a strong Federal Reserve presence, reduced somewhat, would cause prices to rise, in my view, is outweighed by the increase in competition I think it will encourage.

The CHAIRMAN. Senator Hecht.

Senator HECHT. Thank you, Mr. Chairman.

On page 14 you're asking for a 50–50 arrangement. Why did you come up with 50–50?

Mr. SULLIVAN. It's better than 80–20 and 90–10, and it had a certain ring to it. It was basically imprecise based on saying that the collective of the private sector and the public sector in the short run ought to be better balanced than today. Nothing precise about it at all.

Senator HECHT. But who's going to implement this?

Mr. SULLIVAN. I would have no doubt that if this were presented as a sense of Congress to the Fed that they would and could implement it. They would, in effect, have to scale back on some of their marketing efforts in order to achieve that in certain areas and they would also have to do some encouraging of some private sector firms at the same time. I think it's doable, but I think it would take some strong supportive action by the Federal Reserve to achieve it.

Senator HECHT. Well, this morning just Senator Garn and myself are here and you want Congress to act on this. It's a very detailed situation. It's hard to keep a balance of 50–50.

Mr. SULLIVAN. I think it may be hard, but I think it's doable.

Senator HECHT. Let's go on to the next page. On page 16, the second paragraph, why would you want to have another board?

Mr. SULLIVAN. I don't want to get hung up on the word "board." The Federal Reserve today engages in the rulemaking function that we support and believe that it ought to be the rulemaker for the system. What this is saying is that there ought to be in the

process of formulating the rule a better mechanism for getting private sector input.

Today it is done by reaction to rules that are put out for comment and we are proposing that there be more front-end involvement, again saying that the majority would be the Federal Reserve because we believe it's their function.

Senator HECHT. In my short tenure here, every time there's a problem there's a new board spoken about, so that's the reason I always have a bad feeling about a new board. In this particular situation, I don't know why it would be so necessary.

Mr. SULLIVAN. I think the concept we're suggesting—if the word "board" bothers you, we can make it entity, body or something else, but it's a front-end involvement in the rulemaking process rather than a reactive involvement. That's the essential concept that we're after and the particular mechanism of board, or advisory body, or whatnot is less important than the concept.

Senator HECHT. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Hecht.

Mr. Sullivan, thank you very much. We appreciate your willingness to be here today.

Mr. SULLIVAN. Thank you, Senator.

The CHAIRMAN. Our next witness is E. Gerald Corrigan, president, Federal Reserve Bank of Minneapolis.

Mr. Corrigan, before you start, I would like to say that this hearing was originally scheduled for last Friday. Because of some problems with some of the witnesses, we had to postpone it and I'm aware that that caused you some difficulties in rescheduling and you had to cancel some prior commitments to be here today, and I just want you to know the committee appreciates your difficulty in getting here today.

STATEMENT OF E. GERALD CORRIGAN, PRESIDENT, FEDERAL RESERVE BANK OF MINNEAPOLIS

Mr. CORRIGAN. Well, thank you, Mr. Chairman. If I may, Mr. Chairman, I'd like to have my entire statement submitted for the record, but in the interest of the committee's time, I will at this time just review parts of it.

The CHAIRMAN. The full statement will be included in the record.

Mr. CORRIGAN. The central issue that's on the table is the Federal Reserve's role in the payments mechanism. That's what I would like to devote most of my formal comments to this morning.

[The complete statement follows:]

Statement by

E. Gerald Corrigan, President

Federal Reserve Bank of Minneapolis

Mr. Chairman, I am pleased to have this opportunity to review developments over the past three years regarding the priced services activities of the Federal Reserve Banks. My prepared statement is divided into four parts: the first provides an overview of the role of the Federal Reserve in the provision of payments services to depository institutions; the next section provides a general review of our experience with the pricing of such services as required by the Monetary Control Act of 1980; the third section comments on the draft report on such activities prepared by the General Accounting Office at the request of members of this Committee; and, the last section contains some brief remarks on the subject of delayed availability of funds associated with some check deposits.

I. THE ROLE OF THE FEDERAL RESERVE IN THE PAYMENTS MECHANISM

The operation of the nation's payments mechanism is a vast and complex undertaking which daily--directly or indirectly--affects virtually every citizen, every business, and every financial institution in this country and millions of others abroad. For most of us, the act of making or receiving payment is as routine as getting out of bed in the morning. However, because literally hundreds of billions of dollars change hands daily with such reliability and efficiency we should not take for granted the smooth workings of the payments mechanism. The safe, efficient, and trusted operation of the payments system is clearly a matter of high public interest here in the United States and around the world. Indeed, these very considerations relating to the safety and efficiency of the payments mechanism were a central element in the decision of the Congress to create the Federal Reserve more than 70 years ago.

Reflecting in part the legacy of 70 years of experience, I believe there is virtually unanimous agreement that the Federal Reserve, as the nation's central bank, has a natural and continuing interest in the efficient and safe functioning of the payments mechanism. In part, that natural interest arises from the fact that disruptions in the payments mechanism--regardless of their origins--can threaten the safety and soundness of financial institutions, financial markets and, in the extreme, the smooth functioning of the economy at large. However great those concerns may have been 70 years ago, they take on even greater importance in the context of today's highly interdependent domestic and international banking and financial markets.

The point should also be made that transactions balances at depository institutions and the associated reserve balances held at the Fed are, at one and the same time, the vehicle through which most payments are made, the bedrock upon which all other financial flows rest, and the mechanism through which monetary policy is conducted. This trilogy of unique functions is one of the reasons that banks have, in effect, had an exclusive franchise on the operation of the payments mechanism and it is one of the reasons why I believe that banks are special. That trilogy points, in my judgment, to the imperatives of strong banks, strong financial markets, and a strong and efficient clearing system.

To put it more pointedly, the payments system demands the highest degree of public confidence. It simply would not be possible to make hundreds of billions of dollars in payments daily if public confidence in the certainty of payments and the payments process were shaken or undermined. While perhaps

not of the same order of importance, the operation of the payments mechanism inevitably involves other public policy considerations relating, for example, to the ease and terms with which smaller economic entities and more remotely located institutions and individuals have access to the payments system.

The question, therefore, is not whether the central bank has a responsibility to promote the safety and efficiency of the payments mechanism, but rather it is one of how that responsibility can be most effectively discharged. More particularly, should the Fed seek to achieve these public policy objectives by regulation alone; should it act as a processor of last resort, taking on only those functions that others are unwilling to provide or unable to provide at reasonable fees and conditions; or should it maintain an operational presence in the payments mechanism along the broad lines that have prevailed for the past 70 years? From my perspective, the dictates of public policy point strongly in the direction of preserving the operational presence of the Fed in the payments mechanism--recognizing, of course, that the exact configuration of that presence need not, and probably will not, remain as it is today. In saying this I should also stress that an operational presence for the central bank along the general lines of the Fed's current activities is by no means unique among central banks in the industrialized countries of the world.

The processor of last resort concept is deceptively appealing but, in my judgment, is not workable. The Federal Reserve Banks could not maintain the standby facilities, equipment and personnel that would be needed to function on an on-again, off-again basis or to step into those situations in which an

adequate level of payments services might not be available nationwide at reasonable costs and terms. Moreover, even the simplest aspects of the payments mechanism require a continuity of expertise and working knowledge that would be very difficult to maintain in such an environment. Even if feasible, the cost to the taxpayers would be high. Therefore, assigning to the Fed a role as processor of last resort is simply not viable.

In my opinion the United States has--taking account of the size of our economy and the size of our country--the most efficient payments system in the world. That fact cannot be attributed to technological superiority; it surely cannot be attributed to the presence of a neat and clean banking and financial structure. While many factors may be involved, I would suggest that the side-by-side presence of the Federal Reserve and the private banking system in the operation of the payments mechanism has been one of the primary factors that has permitted and encouraged the payments system in the United States to achieve this lofty status.

One can speculate as to whether the result would have been different had the historic role of the Fed been confined to that of a regulator of the payments system. That speculation--however interesting--cannot alter 70 years of experience and it cannot alter the fact of where we are today. Let me cite a few examples that may help to illustrate my point.

-- Is it reasonable to conclude that the book-entry system for U.S. government securities would have been developed as quickly as it was--if at all--if the Fed had been only a regulator rather than a participant in the payments mechanism?

-- Is it reasonable to assume that one or more private entities could, or would even want to, fully displace the Fed's funds transfer network?

-- Is it reasonable to assume that absent a Federal Reserve operational presence 99 percent of the checks written in this vast country with its 40,000 depository institutions would be collected in two days or less?

-- On the other side of the coin, as late as 1979, the Federal Reserve attempted, in the form of a Board policy statement, to put a halt to delayed disbursement of checks. However, we probably have more delayed disbursement of checks today than we did in 1979. The Federal Reserve--through the so-called "high dollar group sort program" which will be implemented on April 23 of this year--is now seeking to achieve through its operations what it could not achieve through "regulation."

The point, of course, is that the payments mechanism is so complex, legally and operationally, that it is far from clear that public policy objectives could be achieved simply by writing regulations. Moreover, it is quite possible that absent the "hands on" working knowledge gained through operations, regulatory efforts would quickly take on an ivory tower character that would be ineffective or impair the efficiency of the payments mechanism or both. There is no doubt in my mind the Fed's operational presence in the payments mechanism is a better alternative than what otherwise would be a cumbersome and very costly regulatory apparatus.

While I am skeptical that regulation alone could provide a cost-effective and efficient method of ensuring that the public policy objectives associated with the operation of the payments mechanism would be well served, there are other aspects of the Fed's operational presence that would be very difficult to duplicate if it were simply a regulator of the payments system. For example, the Fed can be thought of as something of a neutral and trusted intermediary in the payments process. Its only interest is bringing together collectors and payors in the fastest and safest manner possible. It has no particular interest in whether a check is large or small, whether the collecting or paying institution is large or small, or whether the writer of a check is an otherwise valued customer. Indeed, the fact that the Federal Reserve has no relationships with bank customers that are not depository institutions is a feature that makes it an attractive source of payments services for many depository institutions.

This role as a trusted and neutral intermediary is reinforced by the fact that the Fed is also the bankers' bank whose solvency is never in question. This feature permits the Fed prudentially to assume risks such as the intra-day credit exposure on Fedwire or to act as a correspondent for problem banks when others may be unable or unwilling to accept such risks. In tandem, the neutral intermediary and the ever-solvent bankers' bank are aspects of the Fed's role in the payments mechanism which contribute, in no small way, to that essential public confidence in the payments system.

None of the above should be construed to mean that the Fed's operational presence should remain exactly what it is today. Technological developments, the advent of interstate banking, the creative efforts of individual

banks and a host of other factors, no doubt, will change that role over time. Moreover, the Congress may wish to provide different direction to the Federal Reserve asking that we do more, that we do less, or that we do nothing. At this juncture, however, I personally would urge that we retain the legislative status quo.

The bottom line, as I see it, Mr. Chairman, is that the financial system, the business community, and the public at large have been the clear beneficiaries of the Fed's role--in partnership with the banking community--in promoting the highly efficient and safe payments system that we enjoy in the United States. Alternative configurations are easy to conceive but may not be so easy to operate in a way that is appropriately sensitive to those public interest considerations I spoke of earlier.

Much of what I have said about the role of the Federal Reserve is germane to one of the most basic issues raised by the GAO draft report. Namely, whether there is a conflict of interest between the Fed's role as a service provider and a regulator of the payments mechanism. I will readily concede that there is a potential conflict of interest between the Fed's role as a regulator and as a provider of payments services in a competitive environment. However, there are powerful forces which seem to me to more than adequately insure that potential conflicts will never become actual conflicts. These powerful countervailing forces include the generalized public scrutiny of Fed actions, the oversight and general supervisory role of the Board of Governors, the public comment process, the activities of the GAO, and the oversight by the Congress itself.

Moreover, I think the point should be stressed that removal of the Fed from an operational role in the payments system will not eliminate potential conflicts of interest--it will in fact create or intensify other potential sources of conflict. That is, private suppliers of payments services legitimately look first to their customers' and their shareholders' interests in determining the operational posture they will take in providing such services. That is wholly appropriate, but at times it may not yield results that are in the public interest. The payments process is, inevitably, one that entails collisions of interests: payors want to slow it down; collectors want to speed it up; large economic agents have more clout and flexibility than do the small ones. These potential conflicts are subtle and not easy to detect or resolve. The potential conflicts associated with Fed activities--to the extent they are real--are highly visible and readily subject to remedy if abuses were to develop.

Having said all of that, I should hasten to add that there will always be situations in which operational activities of the Federal Reserve Banks impinge on "regulatory" considerations and vice-versa. Let me cite a couple of very contemporary examples:

-- Just two weeks ago, the Federal Reserve Board requested public comment on a wide variety of possible measures for reducing risk in the operation of large-dollar wire transfer systems, including FedWire itself.

-- Beginning on April 23, the Federal Reserve will commence an operational program designed to accelerate the collection of checks

drawn on certain institutions located outside of Federal Reserve cities. In certain instances, the practice of drawing checks on such institutions could undermine the efficiency of the check collection system, raises questions of equity and, in the extreme, also raises questions of safety and soundness.

-- Later in this statement I will make reference to a possible operational change by the Fed that could provide a major step forward in coping with the delayed availability problem on certain check deposits.

In all of these areas, and in others I could mention, we must very carefully weigh operational and policy considerations. In the final analysis, our actions should have a powerful public interest motivation. However, even when the case for a particular action makes overwhelming sense on both operational and public policy grounds some market participants may object to our initiatives on the grounds that our action may be harmful to them or to their customers. I do not think we can or should avoid those problems, but I do believe that the system of checks and balances I referred to earlier provides more than adequate protection against the misuse of regulatory power by the Federal Reserve. Indeed, as I see it those checks and balances may be so tilted that there is the danger of the Federal Reserve not doing things that would serve the public interest simply to avoid "rocking the boat."

II. EXPERIENCE WITH THE PRICING PROVISION OF THE MONETARY CONTROL ACT

During 1983, the Federal Reserve essentially completed the transition to pricing of its payments services to depository institutions as called for in

the Monetary Control Act of 1980. Specifically, the Act required that the Federal Reserve begin by September 1981 to price its payments services so that over the long-run, fees would be established based upon the full costs of providing such services including the cost of float, taxes, and capital the Federal Reserve would incur if it were a private firm.

Within little more than two years of the date which the MCA required the Federal Reserve to commence pricing:

-- all payments services provided to depository institutions have been priced and are now generating sufficient total revenues to cover the full costs of providing such services, including the costs of float, taxes, and capital the Fed would incur if it were a private firm.

-- Federal Reserve services have been opened to all depository institutions regardless of size and location.

-- operational improvements by the Federal Reserve have dramatically reduced the daily average amount of Federal Reserve check float from $4.5 billion in 1980 to a daily average of $1.2 billion in the fourth quarter of 1983. Of the latter amount, $500 million was recovered through "as of" adjustments and explicit fees and the cost of $700 million in "residual" check float was added to the cost base subject to recovery through per-item fees. A major thrust of the Federal Reserve's activities over the past two years was to reduce float to the extent possible through operational

improvements that added only modestly to operating costs. This approach serves both equity and efficiency. If the value of all check float as of 1982 and 1983 had simply been added--across the board--to costs and prices, sizable incentives to increase float--particularly by the writers of large dollar checks--would have been created and the costs of such float shifted to the collection system generally, rather than being borne by those who create and benefit from float.

The transition to the priced services environment was managed not only with a view toward satisfying cost-recovery objectives, but also with a view toward seeking to enhance and improve the efficiency of the payments mechanism. The goal of greater efficiency was served in a number of important respects including, but not limited to, the following:

-- Federal Reserve pricing served as a further catalyst for moving in the direction of electronic payments.

-- Federal Reserve pricing spurred the re-emergence of local clearing arrangements among private depositories. This tended to remove one step in the processing cycle for many local checks, thereby resulting in faster and cheaper clearing services.

-- Changed deposit deadlines, processing cycles, and presentment times at many Federal Reserve offices permitted the shift of checks valued at about $2 billion per day from two-day collection to one-day collection.

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-- It would appear that the amount of society's real resources devoted to the payments mechanism has declined.

-- The Federal Reserve has deployed almost 3,000 low-cost terminals in small- and medium-sized depository institutions, thus providing these institutions with convenient and inexpensive access to a wide range of payments and related services.

These achievements and the rapid transition to a "profitable" base of operations did not come easily. Indeed, I believe it is entirely fair to suggest that the transition to the priced services environment was more difficult and complex--and more contentious--than most of us anticipated at the time the MCA was enacted. Speaking for myself, I think I can also say that if I had to do it over again, there are some things I would have done differently. On balance, however, I believe that the net effect of Fed pricing has been good for the Fed, good for the banking industry, and good for the public at large.

I also believe that with the difficult initial transition to pricing now largely behind us, we in the Federal Reserve are better positioned to turn our attention to the more important questions of what we can do--in cooperation with the banking industry--to foster still further improvements in the efficiency, safety, and integrity of the payments mechanism. These issues loom all the more important in the face of the financial interdependencies that are now such a prominent feature of contemporary financial institutions and markets.

III. THE GAO REPORT ON FED CHECK CLEARING ACTIVITIES

At the request of members of this Committee, the General Accounting Office has prepared a comprehensive draft report regarding the pricing of Federal Reserve check clearing services. The draft report covers a wide range of issues raised by members of the Committee and still others raised by a few commercial banks. The Committee, I believe, is also aware that the Federal Reserve engaged the services of a major accounting firm to take an even more detailed look at other aspects of our priced service activities. That report is a couple of months away from completion, and we will submit the conclusions of the report for the record at that time.

Based on my reading of the GAO report, it seems to me that steps already taken by the Federal Reserve respond to most of the report's major suggestions or recommendations. We will, of course, submit a detailed response to the overall GAO report. There are, however, several areas in which I would offer some further comments at this time.

-- First, we fully agree with the need for more and better disclosure on the part of the Federal Reserve regarding its priced services activities. Toward that end, we have recently issued a "Report on Priced Service Activities for 1983" and contemplate that a similar report--augmented by abbreviated quarterly reports--will be prepared annually. A copy of the 1983 report is appended to my statement (Appendix A).

-- Second, the GAO report strikes me as somewhat cautious on the question of presentment fees and on the specific question of

whether--in some situations--the Federal Reserve should be required to pay presentment fees. This is an area, Mr. Chairman, in which I have very strong views. I believe it would be a mistake to subject the Federal Reserve to presentment fees. If there is a case for legislative action regarding presentment fees, I would argue that such fees should be banned altogether for any check presented to a payor institution in advance of the 2:00 p.m. cut-off hour established in the Uniform Commercial Code. I have also appended to my statement some supplementary comments on this subject (Appendix B).

-- Third, the GAO suggests several areas in which our internal procedures for allocating certain overhead costs to specific priced services might be improved. We are looking closely at these suggestions and others made by our own staff and our accounting firm. Some changes in these procedures have already been made and others will be made but--like the GAO--I do not believe such changes will have a material effect on costs or prices.

While these and other issues raised in the GAO report are important, there are two questions raised in the chapter of the report on "Competitive Issues" which I believe are central. The first is the question of how to assure that the Federal Reserve--with its central bank status and ability to influence the market it serves--continues to exercise its authority responsibly. I have spoken to that issue earlier. The second of these central questions is what response the Federal Reserve should make if it becomes clear that the price the

market will be ultimately willing to pay for a service the Federal Reserve provides is less than what the Federal Reserve must charge to recover its full costs. That latter question comes down to what should the Fed do if it cannot cover its costs in a particular operation? In one sense, the answer to that question is very easy but in another sense it is very difficult. Not every service we provide or might provide has the same degree of public interest considerations associated with it. For example, in considering the efficiency, safety, and integrity of the payments mechanism, nobody would seriously argue that there are great public policy considerations associated with coin wrapping. On the other extreme, I think most everyone would readily concede that there are significant public policy considerations associated with the electronic transfer of reserve balances and securities by the Federal Reserve.

Given these differences in the public interest content of our various services, our response to the question can, in some instance, be rather straightforward. Absent some strong public purpose, a failure to cover costs in a particular service area must lead to the discontinuation of the service in question by the Federal Reserve. Indeed, we may have to face that very situation with respect to certain of our paper securities safekeeping operations. In those circumstances, we are quite prepared to discontinue particular operations but in the process we will have to face some very difficult questions of how and with what speed such services are phased out.

In the case of a service which does not cover costs but is perceived as having a clear public purpose it seems to me that we would have no choice but to consult with the Congress. In the near term, I do not see that situation

arising but over time it certainly could, particularly in the face of the sweeping changes in the structure of our financial system that are almost certain to occur over the next several years. Indeed, the potential for that situation arising is all the greater in a context in which we perceive a strong and continuing interest on the part of the Congress in ensuring that an adequate level of payments services are available to all institutions regardless of their size and location.

There is one other point implied by the GAO report which is relevant to the preceding discussion and warrants a few words. We in the Federal Reserve need to articulate a clear statement of our future role in the operation of the payments system in a priced environment. It was not possible to develop a statement of this nature until the initial transition to pricing had been accomplished. Now that the transition is behind us, we are well positioned to proceed with that task and I would hope that such a statement would be adopted by the Federal Reserve Board by mid-year.

IV. DELAYED AVAILABILITY

Mr. Chairman, I am keenly aware that there is acute interest in this Committee and elsewhere in the Congress in finding ways to stop the practice of excessive delays by some depository institutions in passing credit to their customers on some check deposits. Allow me, therefore, to close with a few brief comments on this subject. My comments are as follows:

-- First, the incidence of abuse in delaying customer availability on check deposits varies considerably from market to market--and from institution to institution--and unfortunately in some cases is far too lengthy.

-- Second, efforts by some states, efforts by depository institutions and their trade associations, interest on the part of the Congress and the recently issued policy statement of Federal financial institutions regulators represent constructive steps in dealing with the problem.

-- Third, I have reservations about efforts to legislate availability schedules in part because there is a danger, however remote, that such legislated schedules could have the perverse effect of encouraging banks that do not delay availability to do so and in part because I believe our objectives should be more ambitious than current procedures and technology would permit. For example, under recently adopted state regulations and as contemplated in some versions of proposed Federal legislation, delays in availability on some checks of up to eight days are authorized. I believe we can do much better and would not, therefore, want to institutionalize delays of that duration.

-- Fourth, in a context in which we are willing to provide some reasonable time for voluntary initiatives to take hold, the Federal Reserve is actively considering a phased in approach to a universal system of wire or telephonic advice of larger dollar return items. With such a system in place, the case for a depository institution delaying funds availability on all checks to protect against the risk of loss on the tiny fraction of items that are returned would be greatly diminished, particularly as the dollar cut-off for wire

advice is reduced over time. This is a good example of how advancing technology can work to produce better results than might be gained through legislatively imposed availability schedules which--to some extent--are captive to current procedures and techniques.

While these steps can help solve or minimize the delayed availability problem, the only solution to the practice--and to the larger problems associated with the mountains of paper payments made daily--is to continue and to accelerate the move toward electronic payments. I said earlier that I believe that one of the benefits of the MCA was that it helped reduce some of the barriers to the more widespread use of electronics in banking for consumers and businesses alike. The technology is certainly there and our younger people--to say nothing of our school-age children--are less intimidated by computer terminals than are many of us. Similarly, the relative costs of paper versus electronic payments continue to shift in a direction that is favorable to electronics. Yet, the current paper-based system provides real or perceived advantages to many--advantages that in substantial ways grow out of the inefficiences of the paper based system including the substantial amounts of non-Federal Reserve float associated with its operations. Thus, seizing the opportunities associated with electronic payments will require a dual effort pushing the efficiency of the paper system to its limit while at the same time developing and exploiting the benefits of electronics.

We in the Federal Reserve are strongly committed to those efforts and to the larger goal of promoting the safety and efficiency of the payments mechanism. We look forward to working closely with the banking industry and others in the furtherance of that goal.

APPENDIX A

FEDERAL RESERVE press release

For immediate release April 9, 1984

The Federal Reserve Board today issued a report summarizing developments in the priced services areas for 1983 and providing detailed financial results of providing those services.

A report on priced services is expected to be issued annually and a financial statement consisting of the Federal Reserve's priced service balance sheet and income statement will be issued quarterly. The pro forma financial statements are designed to reflect standard accounting practices, taking into account the nature of the Federal Reserve's activities and its unique position in this field.

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Attachments

REPORT ON PRICED SERVICES ACTIVITIES FOR 1983

I. OVERVIEW

During 1983, the Federal Reserve essentially completed the transition to pricing of its payments services to depository institutions as called for in the Monetary Control Act of 1980. Specifically, the Act required that the Federal Reserve begin by September 1981 to price its payments services so that over the long-run fees would be established to cover the full costs of providing such services including the cost of float, taxes, and capital costs the Federal Reserve would incur if it were a private firm.

Within a little more than two years of the date which the MCA required the Federal Reserve to commence pricing:

-- All payments services provided to depository institutions have been priced and are now generating sufficient revenues to cover all costs and the private sector adjustment factor (PSAF).

-- Federal Reserve services have been opened to all depository institutions regardless of size and location.

-- Operational improvements by the Federal Reserve have dramatically reduced the daily average amount of commercial check float from $4.5 billion in 1980 to a daily average of $1.2 billion in the fourth quarter of 1983. Of the latter amount, $500 million was recovered through "as of" adjustments and explicit fees and the cost of $700 million in "residual" check float was added to the cost base subject to recovery through per-item fees. A major thrust of the Federal Reserve's activities over the past two years was to reduce float to the extent possible through operational

improvements that added only modestly to operating costs. This approach serves both equity and efficiency. If the value of all check float as of 1982 or 1983 had simply been added--across the board--to costs and prices, sizable incentives to increase float--particularly by the writers of large dollar checks--would have been created and the costs of such float shifted to the collection system generally.

The transition to the priced services environment was managed with a view toward satisfying cost-recovery objectives, but also with a view toward seeking to enhance and improve the efficiency of the payments mechanism. The goal of greater efficiency was served in a number of important respects including, but not limited to, the following:

-- Federal Reserve pricing served as a further catalyst for moving banking in the direction of electronic payments.

-- Federal Reserve pricing spurred the re-emergence of local clearing arrangements among private depositories. This tended to remove one step in the processing cycle for many local checks thereby resulting in faster and cheaper clearing services.

-- Changed deposit deadlines, processing cycles, and presentment times at many Federal Reserve offices permitted the shift of checks valued at about $2 billion per day from two-day collection to one-day collection.

-- The dramatic reduction in Federal Reserve float, in effect, largely eliminated one of the barriers to more widespread acceptance and use of electronic funds transfers.

-- The Federal Reserve has deployed almost 3,000 low-cost terminals in small- and medium-sized depository institutions, thus providing these institutions with convenient and inexpensive access to a wide range of payments services.

II. FINANCIAL RESULTS

In considering the Federal Reserve's financial performance in its priced service activities for 1983, four important qualifications should be kept in mind:

- o First, the PSAF methodology used for 1983 has been revised for 1984. Thus, the PSAF recoveries targeted by the Federal Reserve in 1983 are modestly different in composition and amount than those targeted for 1984.

- o Second, early in 1983, the Federal Reserve accelerated its float reduction and pricing efforts with a view toward eliminating or pricing all check float by the fourth quarter of 1983 rather than in early 1984 as had been contemplated earlier. Thus, the cost/revenue figures for 1983 include the value of all "residual" float for the fourth quarter 1/ but do not include the value of such float for the first three quarters of the year. During the first three quarters of 1983, the amount of check float that was not priced or otherwise recovered amounted to $1.4 billion and was valued at $98.5 million. During 1984, all residual check float will be priced.

1/ The data for 1983 include the cost of all check float in the fourth quarter and any holdover check float in excess of one percent of the total dollar value of checks received for the period February 24 to June 30 and any holdover check float in excess of 0.5 percent of the total dollar value of checks received for the period July 1 to September 30.

- Third, the processing of securities transfers, ACH entries, and coupons from definitive securities can also result in modest amounts of float. Book-entry securities transfer float was added to the cost base as of January 1, 1984; coupon collection float will be added to cost base as of May 1, 1984, and ACH float will be phased in during 1984.

- Fourth, during 1983, the cost/revenue comparisons were influenced by the presence of modest and designed subsidies that have been approved by the Federal Reserve Board for ACH and cash transportation services. The cash transportation subsidy--which was terminated as of December 31, 1983--amounted to $1.6 million in 1983 and the ACH subsidy, which will be phased out by 1985, amounted to $8.1 million in 1983.

With those qualifications in mind, overall fee-generated income for Federal Reserve priced services in 1983 amounted to $496.2 million (see Table 2). Total production costs, net of approved subsidies, amounted to $432.4 million thus yielding $63.8 million in income from operations. Imputed costs, including the value of "residual" check float and the interest cost on short-term and long-term debt associated with the 1983 PSAF, amounted to $40.2 million, while the net interest income from clearing balances amounted to $13.1 million. Thus, the income before allowance for imputed income taxes was $36.8 million. Given the income tax assumption in the PSAF, estimated after-tax income was $22.8 million.

For the year 1983, the Federal Reserve's targeted recoveries for the PSAF were $60.3 million including $20.5 million in interest costs and $39.8 million in pre-tax income. Results for the year as a whole were in line with

the operating targets particularly in the light of the decision to accelerate float pricing. Of course, as noted earlier, since 1983 was the second and last full year in the transition to pricing, the value of float for the full year was not reflected in the cost base or the operating targets.

III. SERVICE-BY-SERVICE RESULTS

As a matter of policy, the Federal Reserve Board adopted in 1980 a pricing principle requiring each of the Federal Reserve's seven service lines 2/ to be managed with a view toward cost/revenue matching for each such service line. This performance standard is a very rigorous one, and it is also one for which financial yardsticks are more difficult to develop. That is, in addition to all the judgments that must be made to arrive at an aggregate pro forma income statement, the service-by-service analysis requires, among other things, that clearing balance income and expense be allocated to specific services. Moreover, since there is no reasonable method for allocating income taxes among service categories, the financial results for each service line are taken to the level of estimated income before tax. With this in mind, however, it can be said--allowing for designed subsidies--that all Federal Reserve service lines (see Table 3) except definitive securities and noncash collection had pre-tax income in 1983 which was in line with operating targets and, as noted earlier, the aggregate pre-tax income was slightly below the overall PSAF recoveries targeted for the year. In the case of definitive securities--which account for only about four percent of Federal Reserve revenues and which were not repriced until mid-1983--the deficit before taxes is about $2.7 million.

2/ The service lines are: (1) commercial check collection; (2) wire transfer of funds and net settlement; (3) commercial automated clearinghouse operations; (4) safekeeping of definitive securities and the collection of noncash items such as interest coupons on municipal securities; (5) the safekeeping and transfer of book-entry securities; (6) cash transportation; and (7) coin wrapping.

Major developments in each service line are discussed below.

Funds Transfers and Net Settlements

Funds transfer and net settlement services were first priced in early 1981 and were repriced in the spring of 1982. Thus, this service has been operating with unchanged prices for almost two years. During 1983, the daily average volume of transfers increased by 7 percent--a very modest increase relative to the pre-pricing trend growth rate of almost 20 percent. Total income for the wire transfer service in 1983 was $57.4 million--up 16 percent from 1982--while production costs rose by 2 percent to $48.8 million. During 1983, the net income before taxes associated with wire transfer and net settlement services was $7.2 million.

Commercial Check Operations

Commercial check operations were originally scheduled to be repriced in August 1982. The 1982 repricing was delayed until late February 1983 due to the controversy surrounding the Federal Reserve's changes in deposit deadlines and presentment times. Those service level changes and corresponding increases in check prices took effect on February 24, 1983. The decision was also made in early 1983 to accelerate the Federal Reserve's float reduction and pricing efforts with a view toward completing that task by the fourth quarter of 1983. The decision to accelerate the float pricing/reduction efforts also required the annual check repricing scheduled for early 1984 to be moved up to December 1983 since the value of "residual" float was built into the cost base earlier than initially

anticipated. Thus, in December 1983, check prices were raised by about seven percent on average with the expectation that such prices would carry through the full year 1984.

Federal Reserve check processing volume grew at a modest rate of 2 percent during 1983. Such growth was, in all likelihood, smaller than the growth in overall check volume during 1983, such that the percentage of all checks cleared by the Federal Reserve continued to drop modestly in 1983 following the sharp decline registered in late 1981 and early 1982. However, the modest growth in volume, together with the service enhancements made by the Federal Reserve and the February and December price increases, yielded a sharp 32 percent increase in revenues for check services to $372.9 million for the year. Reflecting in part the cost of float reduction initiatives, operating expenses for check processing rose by 5 percent to $320.0 million. For the year, pre-tax net income for commercial check operations amounted to $27.8 million.

Commercial ACH

The Board of Governors has adopted a policy to phase out the subsidy for ACH operations over a three-year period ending in 1985. ACH prices were established in early 1983 with a view toward generating revenues that would cover 40 percent of costs and the PSAF with the understanding that the cost recovery targets would be raised annually in increments of 20 percentage points. Commercial ACH volume grew by a robust rate of 48 percent in 1983 and revenue increased by 407 percent to $6.6 million. Commercial ACH operating costs rose by 40 percent to $13.5 million in 1983 and--reflecting the move to the 40 percent recovery rate--ACH costs subject to recovery

rose by $3.5 million to $5.4 million in 1983. Pre-tax net income--after allowance for the designated subsidy--was $1.2 million in 1983.

Definitive Safekeeping and Noncash Collection

Definitive safekeeping and coupon collection is the one area in which the Federal Reserve has not yet been able to generate financial results that are in line with the pricing principles developed by the Board of Governors. These activities were initially priced in late 1981 and were repriced in the fall of 1983. The safekeeping operation in particular experienced sharp volume losses following the advent of pricing, and in many locations volume attrition continues. Coupon collection activities, on the other hand, have recently experienced a sharp rise in volume. Nevertheless during 1983, the service line had an overall pre-tax loss of about $2.7 million. Thus, for 1983, the service line fell well short of the goal of full cost recovery.

Over the course of the year, the combination of (1) the implementation of revised priced schedules in October; (2) rigorous cost containment measures; and (3) the sharp turnaround in coupon collection volume yielded some improvement in the cost recovery picture such that fourth quarter results were markedly better than first quarter results. Pending results during 1984, the role of the Federal Reserve in these activities will be re-appraised.

Book-Entry Securities

The Federal Reserve's book-entry safekeeping and securities transfers services were first priced in late 1981 and were repriced in early 1983. For the year 1983, the daily average volume of securities

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transfers rose by 1 percent--a very modest increase relative to the repricing experience. Income from book-entry operations rose by 40 percent to $18.6 million. Operating costs declined to $15.3 million or by 5 percent. Net income before taxes was $2.9 million.

IV. OUTLOOK FOR 1984

In the wake of the almost breakneck pace of developments over the past two years, 1984 should provide the Federal Reserve and the banking industry a period for some consolidation regarding the Federal Reserve's payment services activities. For one thing, at this juncture, it seems likely that the frequency of changes in Federal Reserve prices or service levels in 1984 will be greatly reduced compared to 1982 and 1983. Indeed, barring the unforeseen, the only major changes now slated for 1984 are the repricing of ACH services, the possible adoption of changes in the fee structure for wire transfer, and the implementation of the program to accelerate the collection of checks drawn on non-city institutions. The Federal Reserve is studying the feasibility of adopting steps in 1984 designed to expedite the processing of return items. The Federal Reserve is also studying a proposal for the direct exchange of checks by collecting and paying banks. However, except for selective price changes that might occur from time to time, no major price changes are now planned for check, book-entry securities, definitive securities, noncash collection, and cash transportation services during 1984. Similarly, it is also expected that volume trends in 1984 will be very much in line with 1983 results, except for the possibility of diminished growth in ACH activities.

The Federal Reserve expects that 1984 revenues for priced services will cover all costs, all elements of the PSAF, and the value of "residual" float. For the year as a whole, service income should rise by 10 to 15 percent, reflecting in large part the full year impact of 1983 price increases.

Production costs are projected to rise by five to seven percent while imputed costs will rise by approximately $20 million, or about 50 percent. The sharp rise in imputed costs reflects the cost of a full year of "residual" float and the addition to the PSAF recoveries of an allowance for sales taxes and FDIC insurance. Assuming net clearing balance income in 1984 is similar to 1983, the Federal Reserve's income and after-tax return on equity should meet that contemplated by the PSAF methodology adopted by the Board of Governors for 1984.

Table 1

Pro Forma Balance Sheet
For Priced Services
Federal Reserve Banks
December 31, 1983
(in millions)

Short-term assets		
Imputed reserve requirements on clearing balances	$147.4	
Investment in marketable securities	1,080.6	
Receivables	49.0	
Materials and supplies	4.4	
Prepaid expenses	2.3	
Net items in process of collection (float)	720.7	
Total short-term assets		$2,004.4
Long-term assets		
Premises	168.7	
Furniture and equipment	91.9	
Leases and leasehold improvements	2.5	
Total long-term assets		263.1
Total assets		$2,267.5
Short-term liabilities		
Clearing balances	$ 1,228.0	
Balances arising from early credit of uncollected items	720.7	
Short-term debt	55.7	
Total short-term liabilities		$2,004.4
Long-term liabilities		
Obligations under capital leases	0.4	
Long-term debt	83.5	
Total long-term liabilities		83.9
Total liabilities		2,088.3
Equity		179.2
Total liabilities and equity		$2,267.5

Accompanying notes are an integral part of these financial statements.

Table 2

Pro Forma Income Statement for Priced Services
Federal Reserve Banks
For the year ended December 31, 1983
(in millions)

Income:		
Services provided to depository institutions		$496.2
Expenses:		
Production expenses	$442.1	
Less: Board approved subsidies	9.7	432.4
Income from operations		63.8
Imputed costs:		
Interest on float	19.7	
Interest on short-term debt	10.4	
Interest on long-term debt	10.1	40.2
Income from operations after imputed costs		23.7
Other income and expenses:		
Investment income	84.9	
Earnings credits	71.8	13.1
Income before income taxes		36.8
Imputed income taxes		14.0
Net income		$22.8
Memo:		
Targeted return on equity		$24.6

Details may not add to totals due to rounding.

Accompanying notes are an integral part of these financial statements.

Notes to the Financial Statements

Balance Sheet (Table 1)

Federal Reserve assets are classified as short- or long-term. Short-term assets represent assets such as cash and due from balances, marketable securities, receivables, materials and supplies, prepaid expenses, and items in the process of collection. Long-term assets are primarily fixed assets such as premises and equipment.

The imputed reserve requirement on clearing balances and investment in marketable securities reflect the Federal Reserve's treatment of clearing balances maintained on deposit with Reserve Banks by depository institutions. For balance sheet and income statement presentation, clearing balances are reported comparable to reporting of compensating balances held by respondent institutions with correspondents. That is, respondent balances held with a correspondent are subject to a reserve requirement as determined by the Federal Reserve. This reserve requirement must be satisfied with either vault cash or with non-earning balances maintained at a Reserve Bank. Following this model, clearing balances maintained with Reserve Banks for priced service purposes should also be subject to reserve requirements. Therefore, a portion of the clearing balances held with the Federal Reserve are identified on the balance sheet as imputed reserve requirements on clearing balances, representing vault cash and due from balances. The remaining amount would be available for investment. For these purposes, the Federal Reserve assumes that all such balances would be invested in three-month Treasury bills.

Other short-term assets reflect the total of: 1) assets directly used in providing priced services, or 2) an allocation of the portion of joint assets used in providing priced services. Receivables primarily reflect

amounts due the Reserve Banks for priced services which have been provided to institutions for which payment has not yet been received. Receivables also include that share of suspense account and difference account balances related to priced services.

Materials and supplies reflect short-term assets necessary for the ongoing operations of priced service areas for which payment has been made. Prepaid expenses represent other prepaid items such as salary advances and travel advances for priced service personnel and the portion of priced service leasehold improvements which will be amortized to current expense during the year.

Net items in the process of collection is the amount of float which will be added to the cost base subject to recovery. Thus, it is the difference between cash items in the process of collection and deferred availability cash items. Therefore, the asset item on the balance sheet corresponds to the amount of float that the Federal Reserve must recover through fees to satisfy the Monetary Control Act. Conventional accounting procedures would call for the gross amount of cash items and deferred availability items to be included on a balance sheet. However, because the gross amounts have no implications for income or costs and no implications for the PSAF calculation, they are not reflected on the pro-forma balance sheet.

Long-term assets that are reflected on the balance sheet have been allocated to priced services using a direct determination basis. This approach was adopted along with other changes in calculating the PSAF for 1984. The direct determination method utilizes the Federal Reserve's Planning and Control System (PACS) to directly associate single-purpose assets and to

apportion assets used jointly in the provision of different services to priced and non-priced services. Additionally, also resulting from changes to the PSAF methodology, an estimate of the assets of the Board of Governors related to the development of priced services will be included in long-term assets in the premises account in 1984.

Long-term assets also include an amount for capital leases. In accordance with generally accepted accounting principles, the Federal Reserve in 1984 will begin to capitalize leases that qualify for capitalization. Leases had not been shown previously on Federal Reserve balance sheets due to immateriality. While the impact in the future is also likely to be immaterial, procedures have been established in order to disclose these assets on a basis consistent with accounting and disclosure practices of private sector firms. These assets also include leasehold improvements. The current portion of leasehold improvements has been included in prepaid expenses.

A matched-book capital structure for those assets that are not "self-financing," has been used to determine the liability and equity amounts. Short-term assets are financed with short-term debt. Long-term assets are financed with long-term debt and equity in a proportion equal to the ratio of long-term debt and equity of the bank holding companies used in the private sector adjustment model.

Other short-term liabilities include clearing balances maintained at Reserve Banks and deposit balances arising from float. Other long-term liabilities consist of obligations on capital leases.

System Income Statement (Table 2)

The income statement reflects the income and expenses for priced services. Included in these amounts are Board approved subsidies, imputed

float costs, imputed financing costs, and the income and cost related to clearing balances.

Revenues reflect charges to depository institutions for priced services. These charges are paid through one of two methods: direct charges to an institution's deposit account or earnings credits. Income includes charges for per-item fees, package fees, explicitly priced interterritory check float, account maintenance fees, shipping and insurance fees, and surcharges. Production expenses include direct, indirect, and other general administrative expenses generated by priced service activities.

Board approved subsidies consist of programs established for the commercial automated clearinghouse and cash transportation services. The incentive pricing program established for the ACH service provides for fee structures designed to recover an increasing share of expenses. In 1983, ACH revenues were intended to recover 40 percent of costs plus the private sector adjustment. This incentive pricing program is being phased out with complete elimination planned in 1985. The transitional support program adopted for the cash transportation service was concluded at the end of 1983. During 1983, the subsidy on ACH operations amounted to $8.1 million and the cash transportation subsidy totalled $1.6 million.

Imputed float costs include the value of float that was intended to be recovered, either explicitly or through per-item fees, during the period. In 1983, imputed costs for the commercial check service included the value of holdover check float in excess of one percent of the total dollar value of checks received for the period February 24 through June 30, 1983, the value of holdover check float in excess of one-half of one percent of the value of checks received and interterritory check float recovered through

explicit charges to depository institutions for the period July 1 to September 30, 1983, and the value of all check float from October 1, 1983. In 1984, float recovery for book-entry securities, ACH, and noncash coupon collection services will be implemented. The implementation of float recovery in 1983 follows float reduction efforts in the past two years that have reduced Federal Reserve float significantly. Total imputed check float costs were $121.7 million and float costs for all services were $137.5 million in 1983. Had all float been intended to be recovered in 1983, the cost of all float would not necessarily have been included in imputed costs since non-monetary charges are available to recover float costs. Also included in imputed costs is the interest on short and long-term debt used to finance priced service assets through the PSAF.

Other income and expenses are comprised of income on clearing balances and the cost of earnings credits granted to depository institutions. For 1983, income represents the average coupon equivalent yield on three-month Treasury bills applied to the total clearing balance maintained. Expenses for earnings credits were derived by applying the average Federal funds rate to the required portion of the clearing balances. In 1984, both the income and expense are to be adjusted for the net effect of reserve requirements on clearing balances.

Imputed income taxes are calculated at the effective tax rate used in the PSAF calculation applied to the net income before taxes.

The targeted return on equity represents the after-tax rate of return on equity that the Federal Reserve would have earned had it been a private sector firm.

Supplemental Financial Data

Service Income Statement (Table 3)

The income statement by service reflects the revenues, operating expenses adjusted for Board approved subsidies, and imputed costs except for income taxes.

Imputed costs include float and the interest on short- and long-term debt as calculated for the private sector adjustment. Float costs are spread based on the actual float incurred in each priced service that is intended to be recovered. Interest on short- and long-term debt are spread based on the ratio of the operating costs less shipping costs in each priced service to the total cost of priced services less shipping costs.

Other income and expenses consist of income on clearing balances and the cost of earnings credits for the Federal Reserve. Since clearing balances relate directly to the Federal Reserve's offering of priced services, the income and cost associated with these balances are spread to each service based on a total income ratio.

Taxes and the after-tax targeted rate of return on equity, as shown on the aggregate income statement, have not been spread by service since these elements relate to the organization as a whole.

Revenue and Expense of Locally Priced Services (Table 4)

This table depicts the financial results for each Reserve Bank in providing locally priced services. The financial results for each Reserve Bank do not include the dollars to be recovered through the private sector adjustment factor and the net investment income on clearing balances.

As such, in order to reconcile Table 4 net revenue data with that disclosed in Table 3, adjustments must be made for the imputed interest on short- and long-term debt and for the difference between income on clearing balances and the cost of earnings credits.

Priced Service Volumes (Table 5)

This table shows the year-to-year volume and percent changes in the number of items handled by the Federal Reserve in its priced service operations. Wire transfer of funds volume is the number of basic transactions originated; ACH volume is the total number of commercial items processed; commercial check reflects the total commercial checks collected; basic transfers originated on-line represent securities transfers volume; noncash collection volume is the number of items assessed fees; and cash transportation volume is the number of armored carrier stops.

Income Statement for Priced Services
Federal Reserve Banks
For the year ended December 31, 1983
(in millions)

	Total	Commercial Check Collection	Wire Transfer and Net Settlement	Commercial ACH	Definitive Safekeeping and Noncash Collection	Book-Entry Securities	Cash Transportation	Coin Wrapping
Income from services	$496.2	$372.9	$57.4	$6.6	$16.3	$18.6	$23.1	$1.4
Operating expenses, net of subsidies	432.4	320.0	48.8	5.4	18.4	15.3	23.4	1.2
Income from operations	63.8	53.0	8.5	1.2	(2.1)	3.3	(0.3)	0.2
Imputed costs	40.2	35.1	2.8	0.2	1.0	0.9	0.1	0.1
Income from operations after imputed costs	23.7	17.9	5.7	1.0	(3.1)	2.4	(0.4)	0.1
Other income and expenses, net	13.1	9.9	1.5	0.2	0.4	0.5	0.6	0.0
Income before income taxes	$36.8	$27.8	$7.2	$1.2	$(2.7)	$2.9	$0.2	$0.1

Details may not add to totals due to rounding.

Accompanying notes are an integral part of these financial statements.

Revenue and Expense of Locally Priced Services at Federal Reserve Banks, 1983

Millions of Dollars

	Commercial Check Collection					Definitive Safekeeping and Noncash Collection			Cash Services				
	Operating Cost	Float Cost	Total Cost	Total Revenue	Net Revenue	Total Cost	Total Revenue	Net Revenue	Operating Cost	Board Approved Subsidy	Total Cost	Total Revenue	Net Revenue
Boston	20.4	0.6	21.1	20.3	-0.7	0.7	0.9	0.2	1.0	0.1	1.0	1.0	-0.0
New York	47.4	5.0	52.4	48.3	-4.1	3.6	2.7	-0.9	3.2	0.0	3.2	3.3	0.2
Philadelphia	12.7	0.0	12.7	12.4	-0.4	1.2	1.0	-0.2	1.2	0.0	1.2	1.3	0.0
Cleveland	19.2	0.1	19.3	23.1	3.8	1.6	1.5	-0.0	1.7	0.0	1.6	1.7	0.1
Richmond	27.1	1.1	28.2	31.9	3.7	0.8	0.9	0.1	1.8	0.0	1.8	1.8	-0.0
Atlanta	34.2	2.4	36.5	44.9	8.4	1.8	2.3	0.5	0.1	0.0	0.1	0.0	-0.0
Chicago	47.9	4.1	52.1	56.1	4.0	3.9	2.9	-1.0	3.6	0.1	3.4	3.1	-0.3
St. Louis	16.6	0.8	17.4	20.0	2.6	1.0	0.8	-0.2	1.3	0.2	1.1	1.2	0.0
Minneapolis	20.3	0.9	21.1	23.9	2.8	0.8	0.6	-0.3	1.5	0.2	1.3	1.4	0.1
Kansas City	23.0	1.1	24.1	27.4	3.4	1.7	1.6	-0.1	1.7	0.0	1.7	1.4	-0.2
Dallas	22.0	0.9	22.9	26.5	3.6	0.9	0.7	-0.1	2.4	0.4	2.0	2.1	0.1
San Francisco	29.1	2.7	31.8	38.0	6.2	0.4	0.4	-0.0	6.8	0.6	6.2	6.1	-0.1
System Total	320.0	19.7	339.6	372.9	33.3	18.4	16.3	-2.1	26.2	1.6	24.6	24.5	-0.1

Details may not add to totals due to rounding.

Accompanying notes are an integral part of these financial statements.

Table 4

PRICED SERVICE VOLUMES

(Items in thousands)	Total			Daily Average		
	1983	1982	Percent Change	1983	1982	Percent Change
Funds Transfers	38,021.0	35,381.0	7.5 %	150.3	140.4	7.1 %
Commercial ACH	155,955.0	105,243.0	48.2	616.4	417.6	47.6
Commercial Checks	14,276,096.0	13,929,959.0	2.5	56,427.3	55,277.6	2.1
Securities Transfers	5,005.2	4,928.5	1.6	19.8	19.6	1.0
Noncash Collection	2,929.7	2,115.5	38.5	11.6	8.4	38.1
Cash Transportation Number of armored carrier stops	556.9	607.5	(8.3)	2.2	2.4	(8.3)

Accompanying notes are an integral part of these financial statements.

APPENDIX B

Presentment Fees

It has been stated that the Federal Reserve has an advantage over correspondents because, under the Federal Reserve Act, Reserve Banks cannot be charged a "presentment fee" by payor banks. The GAO draft report confirms that Reserve Banks are prohibited by law from being charged a presentment fee.

Congress enacted this statutory prohibition in 1917, when nonpar payment of checks was common and was causing inefficiencies in the check-clearing process. Since payor banks did not impose presentment charges uniformly on all presenting banks, collecting banks that would otherwise be subject to a presentment fee attempted to avoid such charges by routing checks sent for collection through a bank that would not be subject to a presentment fee. This circuitous routing of checks consumed unnecessary resources and extended the time period required to collect checks. Indeed, one of the major objectives in creating the Federal Reserve System was to eliminate this obstacle to the speedy collection of checks throughout the country by establishing a check collection system that does not permit payor banks to charge a fee for checks collected through the Federal Reserve.

In order to obtain additional information on industry practices with regard to presentment fees, the Federal Reserve retained a consultant, the ICS Group, to study the matter. The ICS Group concluded that only large correspondent banks typically charge presentment fees. They were advised that no small banks or thrifts charge presentment fees. Further, the ICS Group found that presentment fees are normally charged only on checks that are sent by the collecting bank directly to the payor bank. Presentment fees are not generally imposed upon checks presented through a clearing house to which the payor bank belongs, checks presented by the Federal Reserve, or checks presented under bilateral agreements under which each bank agrees to forego the fees. The fees were found to range from $.01 to $.10 per item, and cluster around the $.015 to $.04 range. The time of presentment (e.g., before or after 2:00 p.m.) was not found to affect whether or not a presentment fee was charged but was found to affect the size of the fee.

As we have indicated previously, rather than impose presentment fees on the Federal Reserve, presentment fees--at least for checks presented before the Uniform Commercial Code's 2:00 p.m. cut off--should be banned altogether.1/

1/ Under the Uniform Commercial Code, a payor bank has an obligation to pay a check presented to it for payment before 2:00 p.m. by its midnight deadline. The Federal Reserve presents no checks after the U.C.C. 2:00 p.m. cut off.

The practice of imposing presentment fees can result in inefficiency and delay in the check collection system to the extent that institutions attempt to avoid these fees through circuitous routings or by holding the check until the next day so it can be presented through a clearing house exchange. This means that checks that could otherwise have been processed and settled are delayed. As the draft GAO report recognizes, the presentment deadlines after which presentment fees are imposed generally are between 8 a.m. and 10 a.m. These cut offs generally were initially set decades ago and have remained unchanged over the years. These deadlines have not been reevaluated to take account of advancements in technology and business practices that have dramatically improved processing and settlement times. Payor banks today clearly have little trouble processing and settling checks received later than 10 a.m. on the day of receipt. Indeed, the GAO draft report recognizes that the Federal Reserve's move to noon presentment has not resulted in significant operational problems for payor banks.

These early presentment deadlines, established by an institution for its own convenience, are a source of delay and inefficiency. If a check is available for presentment and the payor bank is able to process and settle for that check that

day, the check should be presented. Further, any cost that the payor bank incurs in paying a check that has been presented to it for payment (e.g., processing the check to the individual customer account) should be borne by the payor bank or its customer, the person who wrote the check. We can find no reason to transfer these costs, through a presentment fee, to the collector and ultimately to the payee of the check. In addition, transferring these payor bank costs to the collecting bank and payee eliminates the payor bank's incentive to minimize these costs, thus undermining the market discipline that helps to assure that the costs of effecting payments will be minimized. Finally, since presentment fees are not imposed uniformly, they encourage inefficient collection arrangements as collecting banks distort their check collection strategy in order to avoid presentment fees.

THE DELAYED AVAILABILITY PROBLEM

The CHAIRMAN. Thank you, Mr. Corrigan.

In your testimony you just stated near the end of that testimony you support the need for devising a better system to solve the delayed availability problem and the proposed legislation with specific schedule. S. 2181, which has been the subject of much discussion in the last few weeks, calls for a change in the check return system but it does not mandate specific schedule availability.

What do you think of the approach in S. 2181 to this problem.

Mr. CORRIGAN. As I recall, Senator, the thrust of that bill is on disclosure and encouraging better procedures, including these more contemporary endorsement procedures. I think both of those things make a lot of sense.

I would emphasize that the endorsement procedure or standard that's referred to in that bill is a little trickier than it sounds. Saying we're going to have a new endorsement standard seems like a very good thing to do, but every check reader sorter in the country—and there are many, many—would have to be converted to do that. So that's going to take some time. But I certainly think in tandem, the kinds of things that are contemplated in that bill, together with some of the particular things that I mentioned, really could make a dent in this problem.

The CHAIRMAN. You also state that the only solution to this problem is to accelerate the movement for electronic funds transfer. Now even if we're successful in accelerating that, we're talking

about a long number of years before that really takes place. So do we ask consumers to wait that long or don't we try to do something about it in the short run?

Mr. CORRIGAN. Certainly, that is not my intention. There are a couple of important elements here. First, we really have to try and stretch the efficiency of the paper system as far as it can be stretched, and we still have some problems there. The return item issue is part of it, but we still have a lot of checks that are 2-day collection checks rather than 1. We still have a lot of large dollar checks written that create kind of spurious incentives as well. So I think we should be stretching the efficiency of the paper system as far as it can go while at the same time pushing electronics as far as it can go.

On the specific question of delayed availability for consumers, if we were to begin phasing in this wire advice technique in the context of the voluntary steps, I think we could see a material improvement in that whole area in fairly short order, and I would certainly expect that we would see some dividends being paid by the end of this year.

I also think small dollar return items warrant some thought. I personally would not be allergic to some thought being given to the possibility—and this may sound perverse at the moment—of extending the amount of time that institutions have to return items of less than $100 on the grounds that it would provide an extra period of time in which money would get into the account. You would thereby potentially reduce by a substantial amount the number of items that are returned in the first place. If you could deal with the small dollar items that way, and the large dollar items through the wire advice technique that I described before in a context in which all these other things are taking place, I think you've got a ball game.

The CHAIRMAN. Would the return item process be speeded up if the Fed handled all return items regardless of whether the item had been previously cleared by the Fed?

Mr. CORRIGAN. That is tricky. In principle, it sounds like it should work. But we run into some impediments. For example, there are many, many thousands of depository institutions, Mr. Chairman, that do not have a reserve account at the Fed because they satisfy all of their reserve requirements with vault cash. Therefore, we run into the problem of how to charge the institution for the return item. We also have a problem in six States, including the District of Columbia, where the uniform commercial code [UCC], prohibits the direct return to the bank of first deposit.

So, while in principle it does offer some potential gains and some potential efficiencies, those are two not inconsequential impediments to making it work as nicely as it might sound on the surface.

The CHAIRMAN. One of the problems is missing or illegible endorsements and that sort of problem. Could you describe the pros and cons of the ANSI standard?

Mr. CORRIGAN. Well, again, the standard I think is fine. It's the use of the standard that is in question. As I understand it, this endorsement procedure would require that the endorser, which is a mechanical piece on the front end of every check reader sorter that's used in the country, would have to be adapted to conform to

that standard. Basically, the standard contemplates that each endorser, the physical apparatus, would make the first endorsement—I think it's in the upper left-hand corner of the check, so it's very easy to read and they don't get all stamped on top of each other. It's going to take some time to achieve that. It's not an easy matter, even though I concede that it sounds as though it should be, to pull an endorser out of a check sorter and stick another one in. Those machines take a tremendous pounding and are handling 100,000 items an hour. They're very delicate and I know from my own experience that when you're responsible for a big check operation you've got to worry about the float and you've got to worry about downtime and all the rest of it. It's not an easy matter to simply say that we're going to require or we're going to urge that everybody use this endorsing technique. I think it makes a lot of sense. I think we should move in that direction. But I don't think we should have any illusions that it's just going to happen.

The CHAIRMAN. One advantage of the Fed being in this business is only the Fed can pick up business nationwide. Would the Fed support legislation allowing the private sector competitors to pick up and receive deposits nationwide?

Mr. CORRIGAN. I have no objection to that at all, Mr. Chairman. I think to some extent it's already done through various types of arrangements. But, certainly, I have no problem with that at all.

JUSTIFICATION OF SOME OF FED'S PRACTICES

The CHAIRMAN. The justification for the Fed's being in the check clearing business is merely to assure minimum level of service to all communities and all depository institutions. Why should the Fed have marketing representatives out trying to take business away from the private sector competitor?

Mr. CORRIGAN. Well, I don't quite look at it that way. Certainly, the Federal Reserve has no market share objectives whatsoever. In fact, we are seeing a realization of Mr. Sullivan's wishes. In all of the things we do, since the beginning of pricing, our volume has tended to go down and, at least as best as we can judge it, our market share—whatever that is—is also declining. We don't have any problem with that result in the context in which we can continue to do the things that we believe we have been asked by Congress to do.

We certainly do have people in the Reserve banks that make an effort in their local communities to visit with banks and other depository institutions to make them aware of what it is we're doing, what we've got to offer. And I think in general that makes sense. The whole essence of efficient markets presumes that there's good information about prices and terms and all the rest of it.

I think that it does raise some questions. I don't think we should behave just the same way that a private entity behaves, and we try not to behave that way. But on the other side of the coin, if we did not make some efforts along those lines in a judicious way, consistent with our role as a public entity, I think there is a question as to whether or not our capacity to provide these services, match our costs, cover the PSAF and all the rest of it, might be jeopardized. So it is a difficult area. It's an area that requires judgment and it

requires that we be sensitive to what we are, and we are trying very hard to do that.

The CHAIRMAN. Mr. Corrigan, I have no additional questions for you at this time, although I will submit to you some additional questions for your response in writing. Thank you very much for being here today.

Mr. CORRIGAN. Thank you.

[Response to written questions of Senator Garn follow:]

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM

E. GERALD CORRIGAN

PRESIDENT, FEDERAL RESERVE BANK OF MINNEAPOLIS

1. Banks have for some time been criticized for not giving their customers the same availability on deposits which the Federal Reserve gives to the banks for their cash letter deposits. This sort of criticism ignores the real problem, i.e. that the banks remain at risk until sufficient time has passed for a deposited item to reach the payor bank and be returned unpaid. What does the Federal Reserve plan to do to speed up the return item process?

While the exposure to risk of loss has been pointed to by depository institutions as the underlying rationale for not providing customers credit availability comparable to that given by the Federal Reserve to depository institutions, the extent of this risk may be overstated. A loss to the depository institution occurs only in instances where the payee does not reimburse its depository institution for funds that the payee has withdrawn when a check it has deposited is returned unpaid. Of the approximately 40 billion checks written annually, about one percent are returned unpaid. Of this amount, about half are paid when represented for payment. An even smaller volume of return items result in loss to depository institutions since in most instances the institution is able to recover the funds from its depositor. Moreover, as stressed in the recent policy statement issued by the financial industry regulators, depository institutions can and should take additional steps to reduce further their risk of loss without resorting to blanket holds by identifying and isolating those instances, such as large dollar checks deposited into new accounts, that involve an increased risk of loss to the institution.

The Federal Reserve is committed to seeking improvements in return item processing. The return item process is labor intensive, time consuming, and error prone. Through the return item processing pilot being conducted at the Dallas Reserve Bank, the Federal Reserve is testing concepts such as wire advice of nonpayment to the institution in which the check was originally deposited ("institution of first deposit"), the direct return of the physical check to the institution of first deposit, and new processing techniques that would allow the processing of return items on high-speed computer equipment.

An important observation emerging from the Dallas pilot is that from the perspective of the institution of first deposit, early notification of nonpayment of large dollar checks may allow that institution to take action to minimize potential risk of loss. So long as the institution of first deposit receives such information in a timely manner, the time in which the check is physically returned may be of secondary importance. Against this background, the Federal Reserve is exploring the feasibility of providing a nationwide wire notification service to depository institutions. A proposal along these lines will be considered by the Federal Reserve in the near future.

2. New York and California recently enacted legislation mandating specific availability schedules. Based upon the Federal Reserve's past experience, can banks reasonably be expected to clear checks within the time frames allowed by these state laws? Do these availability schedules place banks at risk?

In the process of clearing checks, depository institutions have several collection options. The specific collection path chosen determines the actual collection time. Regardless of whether a depository institution elects to use a correspondent bank or the Federal Reserve, the depository institution would generally receive provisional funds within the availability schedules that are in effect in New York and that are proposed for California. However, there are some categories of checks that may take longer to collect than is provided for in the New York and California schedules. For example, checks that cannot be processed on high speed computer equipment because of their physical condition may take a longer period of time to collect.

If the legislated availability schedules apply to all checks and to all depositors, depository institutions could experience increased risk of loss from check kiting operations. Check kiting activities typically involve new depositors and large dollar checks. An important provision in the New York and California regulations allows the depository institution to extend its availability schedule under certain circumstances that involve an increased risk of loss to the institution. Such a provision should be a necessary part of any legislation that mandates availability schedules.

It should be recognized that any system that requires the movement of paper has the potential for being abused when fixed periods for funds availability are established by statute or regulation for all checks. In this regard, we would again stress our belief that there are opportunities to improve the check collection and return item processing systems in ways that could produce better results than contemplated by legislated availability schedules which, to an extent, must be captive to current arrangements.

3. Please describe in detail how the Dallas Return Items pilot project works. For example, how is the bank of first deposit identified, how are the items returned and how is settlement made?

The Dallas return item pilot program began in February 1983 and consists of four phases. Currently, the Dallas Reserve Bank accepts returned checks only if the check was collected originally through the Federal Reserve. Upon receipt of a returned check from the institution upon which the check is drawn ("payor institution"), the Dallas Reserve Bank determines the institution of first deposit by reading the endorsement stamps on the back of the check. The Reserve Bank notifies the institution of first deposit by wire or telephone ("wire notice") of the large dollar checks ($2,500 and above) being returned. In view of the large volume of small dollar checks and the relatively small dollar amounts involved, it is not currently cost effective to provide wire notice for such checks. All of the checks being returned to the institution of first deposit are delivered directly to that institution by courier (or in some instances the U.S. mail) if the institution is located in the Dallas Federal Reserve District. Checks being returned to institutions outside the Dallas Federal Reserve District follow the normal endorsement chain, i.e., they are returned to the Reserve Bank that is the Dallas Reserve Bank's immediate endorser. Settlement is achieved by posting entries to the appropriate depository institution accounts maintained at the Reserve Bank. If an institution does not maintain an account with the Federal Reserve, the entries are posted to the account of that institution's correspondent bank.

In the next phase of the pilot program, the Dallas Reserve Bank will accept returned checks that were collected originally outside the Federal Reserve System, provided that both the payor institution and the institution of first deposit are located in the Dallas Federal Reserve District. Before settlement for these checks can be accomplished, written agreements between the institution of first deposit and the Federal Reserve must be completed. The agreement authorizes the Federal Reserve to charge the institution of first deposit for the returned check even though the Reserve Bank did not handle the check during the collection process. In the final phase of the pilot, the Dallas Reserve Bank will accept all returns from any payor institution in the Dallas Federal Reserve District, regardless of whether the check was originally collected through the Federal Reserve or whether the institution of first deposit is located within the Dallas Federal Reserve District. Checks will be returned directly to institutions of first deposit located in the Dallas Federal Reserve District and to the Federal Reserve offices of institutions of first deposit located outside the Dallas Federal Reserve District.

4. The Dallas Return Items pilot project has been in existence for over two years. Has it yielded meaningful results? If so, what are they and what changes in the return items process do they suggest? If not, when can such results be expected and when is the project expected to end?

The Dallas return item pilot program began in February 1983. Preliminary analysis indicates that most checks are being returned faster than under previous procedures. However, a small percentage of checks are being returned slower, particularly where courier arrangements between the Federal Reserve and the institution of first deposit do not exist. We estimate that the Dallas pilot on average has sped up the return of checks by one day. After an assessment of the improvements that can be realized, we will then be able to determine whether the effects of these savings, including possible reductions in delayed availability practices of depository institutions, if any, outweigh the additional costs. Increased costs result, for example, from returning checks directly to institutions of first deposit that do not currently have courier arrangements with the Federal Reserve and from the increased processing required to sort to institutions of first deposit rather than to prior endorsers. (Sorting to institutions of first deposit rather than to prior endorsers would increase the number of locations to which checks are returned by approximately 400 percent).

In this regard, as detailed in the response to question 8, the preliminary results of the Dallas pilot suggest that wire notification directly to the institution of first deposit of large dollar returns provides a particularly promising approach to begin to reduce materially the problems associated with returned checks.

5. What specific operational issues have been encoutered with respect to the Dallas pilot (refer to Paul A. Volcker's letter to Thomas R. Carper, dated February 24, 1984)? What is being done to resolve them?

Under the return item pilot program, the Dallas Reserve Bank has experienced operational problems in the preparation of wire notices, the reading of endorsements, and the handling of returned checks specially prepared for automated processing. Although the volume of returned checks has not increased, there has been a large increase in the number of wire notices. At the present time, the Dallas Reserve Bank is providing wire notice to the institution of first deposit on all large dollar returned checks ($2,500 and above). Prior to the pilot program, the Dallas Reserve Bank provided wire notice only when it received a wire notice from the returning institution. The Reserve Bank received such notice on about 40 percent of the large dollar returned checks. In addition, prior to the pilot program, the Dallas Reserve Bank provided the wire notice to its prior endorser. Notice to the institution of first deposit requires the Reserve Bank to contact a larger number of institutions. This increase in the number of wire notices initially resulted in the delay of some of the notifications. The Reserve Bank has been able to resolve this problem by an increase in staff.

The Dallas Reserve Bank is currently sorting returned checks by institution of first deposit. Prior to the pilot program, the Reserve Bank sorted returned checks by its prior endorser. As a result, return item clerks currently have to identify the endorsements of a significantly larger number of institutions. In addition to being unfamiliar with endorsements of many institutions of first deposit, return item clerks

initially experienced difficulty in identifying these endorsements, which are often obscured by endorsements of subsequent endorsers or are illegible because of poor quality control on endorsement stamps. Through experience, the Dallas Reserve Bank has been able to reduce the impact of endorsement problems on processing productivity.

The Dallas Reserve Bank is currently experimenting with procedures to facilitate the automated processing of returned checks. Specifically, the Dallas Reserve Bank is experimenting with sorting specially prepared returned checks on high speed sorting equipment. High speed sorting equipment can be used because the institution of first deposit's computerized routing number is placed on the front of the check. Some of these institutions were mistakenly reentering these checks for collection without removing the specially prepared payment information. Accordingly, these checks would be presented for payment to the institution of first deposit rather than to the payor institution because the institution of first deposit's routing number remained on the front of the check. These problems appear to have been resolved by adjustments these institutions of first deposit have implemented.

In virtually all aspects of this experiment, the Dallas Reserve Bank has found it necessary to spend a good deal of time and effort on employee training. Indeed, at each step along the way, experience with particular operations has improved over time as training efforts and day to day operating experience takes hold.

6. What, if any, plans does the Federal Reserve have to experiment with new technology in an effort to improve the return items system? Does the Federal Reserve plan to automate the return items process? Specifically, what possible approaches to return items automation might be considered?

The Federal Reserve is in the process of replacing existing return item sorting machines with equipment that provides for faster sorting. This new equipment, however, operates at substantially slower speed than the high-speed sorting equipment used to process checks for collection. As detailed in the response to question 5, the Dallas Reserve Bank is experimenting with processing specially prepared return items on high speed sorting equipment. In this regard, the Dallas Reserve Bank, under its return item pilot, provides a price incentive to encourage depository institutions depositing return items with the Federal Reserve to prepare them for automated processing.

As detailed in the response to question 8, wire notification directly to the institution of first deposit of large dollar returned checks offers a potential example of using higher technology to improve the efficiency of the return process. In this regard, the Federal Reserve has been actively involved in the deployment of low cost terminals--particularly in smaller depository institutions--which provide an efficient and relatively secure means for providing such wire notification as well as other electronic services.

7. What information can the Federal Reserve furnish to the Congress with respect to the time it takes the Federal Reserve to process return items? Specifically, can the Federal Reserve furnish statistics as to the average amounts of time it takes the various Reserve Banks to process return items (both intradistrict and interdistrict) from the time of receipt by the Federal Reserve until the time of delivery to the bank of first deposit? What are the fastest and slowest times within which the Reserve Banks return items to the depositary bank?

Return items generally are processed the same day they are received by a Federal Reserve office and sent to the institution that originally sent the check to the Federal Reserve for collection ("depositing institution") early the following morning. Checks that are deposited and drawn on institutions in the same Federal Reserve territory will generally be received by the depositing institution on the day after they were returned to the Federal Reserve. For example, returned checks received on Monday by the Federal Reserve would be processed that day and delivered to the depositing institution on Tuesday. In some cases where the U.S. mail is used to deliver returned checks, the checks may not be received by the depositing institution until Wednesday.

Checks being returned to depositing institutions located in territories served by other Federal Reserve offices require at least one additional day for processing by the second Federal Reserve office. For example, a check returned on Monday to the local Federal Reserve is dispatched that night to the second Federal Reserve office. The second office processes the check on Tuesday and dispatches it to the depositing institution on Wednesday morning. If the U.S. mail is used, the check may be received by the depositing institution on Thursday.

Accordingly, on average the fastest time for the return of a check to the depositing institution is one day after the check was received by the Reserve Bank and the longest time is three days.

8. Is it true that it may take the participants in a check collection as long as two weeks to return a check to the bank of first deposit, even when each of the participants has acted timely under the Uniform Commercial Code? How is this possible?

A check is typically returned step by step through each institution that originally collected the check. Under the Uniform Commercial Code (U.C.C.), each institution has until midnight of the banking day following the banking day it received the check to make timely return (U.C.C. §§ 4-302 and 4-104(h)). Furthermore, it takes additional time to transport the check physically between each of the institutions in the original collection chain. Consequently, depending upon the extent to which the U.S. mail is used for transportation, the number of institutions involved in the collection of the check, the intervening weekends and holidays, and the geographic location of the institutions, it may take as long as two weeks for a check that the payor institution has dishonored to be returned to the institution of first deposit.

The time-consuming nature of the current return item process highlights the importance of providing notice to the institution of first deposit that a check is being returned as soon as possible. The quicker the institution and its customer are aware that a check is being returned, the quicker they can take action--and the more likely they will successfully be able--to protect themselves. The Federal Reserve currently is exploring the possibility of returning payment information directly to the institution of first deposit. Under this program, the Federal Reserve would provide wire notice of dishonored checks above a certain dollar amount directly to the institution of

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first deposit. This service could be available both for checks originally collected through the Federal Reserve and for checks originally collected outside the Federal Reserve.

A Federal Reserve wire notification service could normally provide the institution of first deposit and its customer notice that a large dollar check is being returned sooner and with a lesser expenditure of resources than current procedures. Furthermore, it has the potential of providing the benefits generally associated with direct return of the check.

9. Missing, illegible and obscured endorsements chronically hamper the ability of payor banks to route return items quickly to the bank of first deposit. Does the Federal Reserve have any proposals for improving this situation? Please describe the pros and cons of the proposed ANSI standard and the Federal Reserve's position on the standard. Are there superior alternatives? What are they?

Experience with our return item experiments indicates that although determination of the institution of first deposit does not represent an insurmountable problem, particularly after training of personnel, considerable time and effort could be saved by the industry if it implemented an endorsement standard.

Adoption of the ANSI standard may require extensive investment in new check processing equipment and make some of the current equipment obsolete. Thus, if the ANSI standard were to be implemented it should be done in an orderly fashion over time.

10. Does the nationwide adoption of a direct return of items provision in the Uniform Commercial Code seem likely to occur in the near future? If not, is federal action desirable?

We have discussed with officials in the District of Columbia, Nebraska, Nevada, New Jersey, Oregon, and Wisconsin the desirability of changing their local commercial codes to add the provision provided in section 4-212 of the Uniform Commercial Code, which permits institutions to return an unpaid check directly to the institution of first deposit. Currently in these jurisdictions, a check may have to be returned step by step back through each institution involved in the original collection of the check absent agreement of the parties to the contrary. All other states have adopted the section 4-212 direct return provision.

While all of the officials with whom we discussed this issue appeared receptive, this matter does not appear to be a high priority on the legislative agenda in some of these jurisdictions. Until these laws are changed, many of the benefits envisioned from the return of checks directly to the institution of first deposit will not be realized nationwide because institutions would be uncertain as to whether the institution they send checks to will return the unpaid checks directly to them or through each institution in the collection chain. Consequently, if these jurisdictions are unable to modify their commercial codes in a reasonable period of time, Congress may wish to consider the desirability of authorizing the direct return of dishonored checks directly to the institution of first deposit.

11. Would the Federal Reserve support legislation which would permit payor banks to hold unpaid items beyond the midnight deadline, if necessary, in order to make use of couriers which would deliver return items to the bank of first deposit considerably faster than the U.S. mail?

As indicated in the response to question 8, the critical element in dealing with returned checks is to inform the institution of first deposit and its customer that the check is being returned in as timely a manner as possible. Once the institution is advised that a particular check is being returned (e.g., through wire advice), it and its customer can take action to protect themselves from potential loss. Accordingly, I would not object to extending the midnight deadline for a short time, such as several hours, to permit depository institutions to use a more cost effective means (e.g., existing courier arrangements) to return a check if the institution of first deposit is also provided wire notification of the return.

12. Would the Federal Reserve support legislation which would extend the midnight deadline for up to 72 hours for small-dollar items (e.g. $100 or less) in order to allow sufficient funds to be deposited to honor the item thereby reducing the returns and redeposits of small-dollar items?

Although small dollar checks represent the vast majority of returned checks, they account for a small portion of all dollars returned. In addition, a large proportion of these checks are paid when they are presented to the payor institution a second time. This suggests that an extension of the midnight deadline for small dollar checks--at least for those returned for insufficient funds--could result in a substantial reduction in the number of returns. Moreover, the problems associated with delayed availability generally do not appear to arise with regard to small dollar checks because many depository institutions do not delay availability on small dollar checks and because depositors typically have other balances in their account sufficient to cover checks they have drawn. Finally, it does not appear cost effective to provide wire advice of dishonor or speed the return of the check itself directly to the institution of first deposit with regard to small dollar checks. For these reasons, I personally believe it would be appropriate to extend the midnight deadline for small dollar checks for a reasonable period of time, perhaps up to 72 hours, in order to enable the depositor to deposit funds to cover such unpaid checks.

13. It is estimated that the Federal Reserve advice of nonpayment is actually given in less than 50% of the cases where it is required and that in most cases where the advice is given, the information is not sufficient to permit the recipient to act upon it. Does the Federal Reserve have data which indicate whether its uniform instructions on advice of nonpayment yield beneficial results? To what extent do banks give the advice when required to do so? To what extent, if any, have depositary banks been able to expedite availability to customers in reliance on the absence of an advice of nonpayment? To what extent can banks safely rely on the information contained in advices to charge customers' accounts? What recourse does a bank have to the Federal Reserve or other banks if it relies on such information to its detriment? Are there ways to make the advice more effective?

Currently, when the Federal Reserve receives from the payor institution wire notification that a large dollar check (over $2,500) is being returned, the Federal Reserve provides wire advice of return to its prior endorser. This wire advice travels from institution to institution back through the collection chain until it reaches the institution of first deposit.

It is not possible to provide statistical information on the benefits of wire notification because it has not been extensively used. The institutions in the collection chain often do not provide the wire notification. For example, as indicated in question 5, the Dallas Reserve Bank received notification on only about 40 percent of the large dollar returned checks it received prior to implementation of its pilot program. However, an industry study concluded that the risks inherent in the return item process could be minimized through wire notification of return.

An institution of first deposit that currently relies upon a wire advice to charge a customer's account may have recourse to an institution providing an erroneous wire advice if that institution failed to exercise

ordinary care and the damages incurred by the institution of first deposit would have been avoided had ordinary care been used. It should be noted that the institution of first deposit need not charge its customer's account to protect itself from potential loss. Rather, it can protect itself by placing a hold on the customer's funds in question until the returned check is actually received.

One of the objectives of the Dallas Reserve Bank's return item pilot program is to determine if the effectiveness of the wire notification procedures can be improved. The Dallas Reserve Bank is currently experimenting with providing wire notification of return directly to the institution of first deposit, thus skipping the other institutions in the collection chain. Under a Federal Reserve wire notification program, the Federal Reserve might warrant the accuracy of the information in the wire advice. Accordingly, the institution of first deposit would have recourse against the Federal Reserve for errors in the wire advice due to the Federal Reserve's own lack of good faith or failure to exercise ordinary care.

14. Will the Federal Reserve agree to handle return items regardless of whether the items have been previously handled by the Federal Reserve? What federal action, if any, would be necessary to achieve this result?

The Federal Reserve currently has the authority to handle return checks that were originally collected outside the Federal Reserve. In this regard, the Dallas Reserve Bank is experimenting with the direct return of checks that were not originally collected through the Federal Reserve.

While the direct return by the Federal Reserve of checks not originally collected by the Federal Reserve has considerable conceptual appeal, there are a number of practical problems such as how to return checks in a timely and cost effective manner to institutions of first deposit with whom the Federal Reserve has not established courier arrangements and how to effect settlement for institutions of first deposit with whom the Federal Reserve has not established charge agreements. These issues need to be resolved before a Federal Reserve direct return service for all checks, regardless of whether collected initially through the Federal Reserve, could be viable.

15. Doesn't the Monetary Control Act of 1980 require that the Federal Reserve charge for return item services on a per item basis rather than "bundle" return item services with check collection services for fee purposes? How does the Federal Reserve distinguish this sort of bundling from an illegal tying arrangement?

The Monetary Control Act of 1980 provides that the Federal Reserve shall begin putting into effect a fee schedule for Federal Reserve services beginning in September, 1981 based upon certain pricing principles. Among the services specified in the Act is "check collection." The check collection process is composed of many distinct elements, including processing numerous "classes of checks," transportation, return of unpaid checks, and reconcilement and adjustment of certain items. The Act does not require that each element in the check collecting process be charged for separately and such an arrangement would be wholly unworkable. For example, the costs of maintaining accounting records for checks collected by the Federal Reserve need not be separately charged for. Establishing one fee for the collection and return of a check does not constitute a tying arrangement because the return of an unpaid check is an integral step in the collection process.

16. Does the Federal Reserve permit settlement of direct return items on its books where the items are not handled by the Federal Reserve? If not, why not? What federal action, if any, would be necessary to achieve this result?

The Federal Reserve provides a net settlement service for all depository institutions. Depository institutions can utilize this service for settlement of net debits and credits so long as each party involved in the transaction has authorized the Reserve Bank to charge its or its correspondent's account. Account entries, however, could not be made if a depository institution refuses to authorize a Reserve Bank to charge an account for a check returned directly to it. Accordingly, settlement of check returns could take place through the Reserve Bank only if the institution to which a check is being returned has authorized the Reserve Bank to charge an account.

17. Currently, the Federal Reserve is the only entity whose authority to pick up deposits nationwide is unquestioned. Does the Federal Reserve support legislation which would permit depository institutions to pick up or receive deposits from correspondents and the Federal Reserve regardless of any federal or state law restricting the number or the physical location of the depository institution? If not, why not?

Although the Federal Reserve's nationwide presence may provide an advantage, this advantage is not as large as it may appear at first impression. Services on a wide geographic basis are also provided by correspondent banks, which have established and participated in arrangements involving transportation of checks from customers on an intra- and inter-state basis. Correspondent banks often work in tandem with their own processing centers, subsidiaries of the parent bank holding company, or unaffiliated processors located throughout the country. Correspondent banks have also determined that it is not even necessary to have a nationwide operating presence to compete on a nationwide basis. These institutions have established arrangements with couriers for nationwide pickup of checks and shipment to the institutions' main office for processing. We anticipate that this trend will continue and correspondent banks will increasingly offer services on a nationwide basis, particularly if and when interstate banking is authorized. In this regard, we would welcome legislation that would confirm the ability of depository institutions to pick up or receive correspondent deposits without regard to branching and interstate banking restrictions. It is important to note that if and when interstate banking is authorized, we believe that the underlying public policy rationale for a Federal Reserve operational presence in the payments mechanism will remain as compelling as it is today.

18. How does the Federal Reserve justify not placing its endorsement on all items handled by it? Doesn't this practice make the return items task more difficult for payor institutions while making the Federal Reserve's processing task easier?

The Federal Reserve places an endorsement on all items that it processes through reader sort equipment. However, the Federal Reserve also offers a program, called "fine-sort," whereby depositing institutions may deposit checks that have been presorted and packaged according to payor institution. The Federal Reserve delivers these checks to the payor institutions along with the checks the Federal Reserve has itself processed.

The collection of checks in the fine sort program is accelerated because they can be deposited later than other check deposits. In addition, the fine sort program is the most efficient method of collecting checks in certain instances, such as when an institution of first deposit has a relatively large number of checks drawn on a particular payor institution.

Although the lack of the Federal Reserve endorsement on checks collected through the fine sort program may be a source of inconvenience for some depository institutions, primarily the larger institutions that may receive checks from several sources other than the Federal Reserve, the fine sort program does not result in significant problems in the return item process. We believe the fine sort program results in improvements in the speed and efficiency of the nation's check collection system that outweigh any small inconveniences to some depository institutions.

19. How does the Federal Reserve justify its practice of not microfilming cash letters? Shouldn't the Federal Reserve bear the cost of reconstruction if it loses a cash letter?

The microfilming requirement arises out of the Bank Secrecy Act. Under the Act, depository institutions are required to microfilm only checks drawn on the institution itself. Therefore, only payor institutions, not collecting or processing institutions, are required to microfilm. The Reserve Banks generally are not payor institutions. Thus, neither the Reserve Banks nor the correspondent banks are required to microfilm checks for which they are a collecting, rather than a payor, institution.

The purpose of the legislation, enacted in 1970, was to require depository institutions to maintain appropriate types of records that may have a high degree of usefulness in criminal, tax or regulatory investigations or proceedings. This type of record-keeping was required due to the increased use of depository institutions by criminals. Law enforcement officials believe that effective prosecution of criminals depends in part upon the maintenance of adequate records by depository institutions of checks drawn on deposit accounts that can be used as evidence to trace criminal activity. The Bank Secrecy Act, adopted for law enforcement purposes, enables law enforcement officials to obtain evidence of the activity in accounts held with depository institutions that may aid in the prosecution of criminals. Because the Reserve Banks do not offer deposit accounts to the public, there is little reason to subject them to the requirements of the Act. Furthermore, for privacy reasons, the Federal Reserve has a long-standing policy

of not recording or retaining payment records that could identify the individuals involved in the transaction. Under this policy, the Reserve Banks neither microfilm commercial checks nor retain detailed payments data made in either paper or electronic form.

While banks may generally microfilm all deposited checks and checks in transit before sending out a cash letter, this is not a result of the Treasury regulation. Most banks make a practice of microfilming all checks that pass through their check clearing process as a means of reducing the problems associated with a lost or destroyed cash letter, or damage by a reader sorter. This practice is not required by the Treasury regulation, and, in fact, was a standard business practice at the time the regulation was issued. It would be a duplication of efforts for the Federal Reserve also to microfilm the checks it process.

With regard to covering the costs of reconstructing a lost or damaged cash letter, the couriers that have a contract with the Federal Reserve to transport checks are required to have insurance to cover the the costs of reconstructing a lost or damaged cash letter. If one of these couriers loses or mishandles a cash letter, the depository institution depositing the cash letter with the Federal Reserve will be reimbursed by the courier for the cost of reconstructing the cash letter. The Federal Reserve indirectly pays these costs through the fees charged the Federal Reserve by the couriers, which incorporate the insurance costs of the couriers.

20. How does the Federal Reserve justify its limitation of warranties in Regulation J when banks sending to the Federal Reserve are required to make all Uniform Commercial Code warranties?

The warranties made by Reserve Banks under Regulation J are essentially the same as those made by depository institutions under the Uniform Commercial Code ("U.C.C."). Under the U.C.C., a depository institution presenting a check to a payor institution[1/] generally warrants that (1) it has good title to the check or is authorized to obtain payment; (2) it has no knowledge that the signature of the drawer is unauthorized; and (3) the check has not been materially altered. Under Regulation J, a Reserve Bank specifically warrants that it has good title to the check or is authorized to obtain payment and that the check has not been materially altered. Furthermore, the Reserve Bank is also liable under Regulation J for lack of good faith and failure to exercise ordinary care, which includes failure to take appropriate action once it has learned that the signature of the drawer is unauthorized. Accordingly, the warranties made by the Reserve Banks under Regulation J are in practice the same as those made by depository institutions generally under the U.C.C.

1/ Reserve Banks typically present checks to payor institutions. In those instances in which Reserve Banks present checks to other collecting institutions rather than to the payor institution, the warranties, although slightly different, are again essentially the same as those made by a depository institution under the U.C.C.

21. To what extent does the Federal Reserve incur losses annually as a result of its failure to route items properly or its failure to handle items in a timely fashion? How do these losses compare with those experienced by the banks with which the Federal Reserve competes?

For 1983 the Federal Reserve incurred losses amounting to approximately $70,000 resulting from checks that were delayed in being presented or returned. There is no comparable figure reported by depository institutions.

22. Under Regulation J, the Federal Reserve maintains an availability schedule for sending institutions but reserves the right to refuse at any time to permit the use of credit if the Reserve Bank has not received "actually and finally collected funds"? Is this consistent with the Federal Reserve's policy on funds availabilty?

The provision in Regulation J allowing Reserve Banks to refuse to permit the use of credit for a check for which payment has not yet been received is fully consistent with the Federal Reserve's policy on funds availability. It is the policy of the Federal Reserve to make credit available to institutions depositing checks with a Reserve Bank according to published availability schedules. However, a Reserve Bank reserves the right to suspend the availability schedule and withhold availability in exceptional circumstances where there is doubt about its ability to recover its credit if the check in question is dishonored. In practice, Reserve Banks exercise this option in very few cases.

This is fully consistent with the Federal Reserve's policy, as enunciated in the March 22, 1984, joint policy statement of the financial industry regulators, that institutions identify and isolate specific instances posing the potential for increased risk of loss rather than impose blanket holds on all depositors. The policy statement states that in reviewing funds availability policies "[i]nstitutions should take into account factors that indicate whether a given situation presents a risk of loss that justifies a delay in availability."

In this regard, both the regulations implemented in New York and proposed in California provide for suspension of the normal availability schedules in those cases that pose a relatively high risk to the depository institution. For example, under the New York regulations, a depository institution may delay availability until it has received actually and finally collected funds in those cases where it in good faith doubts the collectibility of the funds.

23. Under Regulation J, the Federal Reserve is agent only of the sender of an item. It is not agent or sub-agent of the actual owner as are all other collecting banks under U.C.C. § 4-201. As a consequence, the Federal Reserve is not exposed to direct claims by the customer of the bank of first deposit while other collecting banks are. What is the justification for this difference?

The "sender only" rule of Regulation J (§ 210.6(a)(1)) originated in 1924, when there was no uniform law governing bank collections. At that time, each state had check collection rules established by statute or judicial decisions that may have differred in many respects from rules in other states. In order to adopt a uniform policy with regard to checks collected through the Federal Reserve, the Federal Reserve Board in 1925 adopted the same rule relating to its liability that the Supreme Court had adopted as federal common law. Under this rule, each collecting institution was the agent only of its immediately preceding endorser. However, when the Uniform Commercial Code was enacted by the states, it established the rule that each collecting institution is the agent of the owner of the check being collected.

Continuation of the sender rule may be appropriate in view of the Federal Reserve's unique role in providing check collection services to all depository institutions regardless of location. In contrast, correspondent institutions may pick and choose among the institutions they choose to serve and can refuse to deal with an instuitution on any basis including the likelihood of possible liability. However, the Federal Reserve is reviewing the effects of the sender rule to determine whether it should be modified in view of current conditions.

24. Under Regulation J, paying banks returning items through the Federal Reserve are required to warrant to the Federal Reserve that they took all necessary action under Federal Reserve, Uniform Commercial Code and Clearing House rules and to agree to indemnify the Federal Reserve in case of breach of such warranty. The Federal Reserve, with its regulatory authority and national check clearing system, is in a unique position to require such terms. Would the Federal Reserve be able to impose such terms as a competitor in the private sector?

The warranties provided by a payor institution under Regulation J are substantially similar to the obligation undertaken by a payor institution under the U.C.C. Section 1-203 of the U.C.C. requires a payor institution to act in good faith in the performance of its duty. "Good faith" is defined by the Code as "honesty in fact" in the conduct of a transaction. Under § 4-302(a) of the U.C.C., a payor institution is accountable (i.e., absolutely liable) to a presenting institution if a check it has dishonored is not returned in a timely fashion. Regulation J imposes a similar obligation through the language contained in § 210.12(b). Consequently, a payor institution undertakes essentially the same obligation for checks it returns under both Regulation J and the U.C.C.

Further, all depository institutions may enter into special collection agreements providing alternative time limits and conditions for the return of checks. The ability of depository institutions to enter into these arrangements is specifically recognized in § 210.12(b) of Regulation J and § 4-103 of the U.C.C.

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25. The Federal Reserve refuses to pay presentment fees imposed on all other banks when presenting items after a clearing house cutoff hour. What is the justification for this practice?

Section 16 of the Federal Reserve Act prohibits the Federal Reserve from paying presentment fees. Congress enacted this statutory prohibition in 1917, when nonpar payment of checks was common and was causing inefficiencies in the check clearing process. Since payor institutions did not impose presentment charges uniformly on all presenting institutions, collecting institutions that would otherwise be subject to a presentment fee attempted to avoid such charges by routing checks sent for collection through an institution that would not be subject to a presentment fee. This circuitous routing of checks consumed unnecessary resources and extended the time period required to collect checks. Indeed, a significant objective in creating the Federal Reserve System was to eliminate this obstacle to the speedy collection of checks throughout the country.

The practice of imposing presentment fees can result in inefficiency and delay in the check collection system to the extent that institutions attempt to avoid these fees through circuituous routings or by holding the check until the next day so it can be presented through a clearinghouse exchange. The presentment deadlines after which presentment fees are imposed generally are between 8 a.m. and 10 a.m. These cut offs often were established decades ago for the institutions' own convenience and have not been reevaluated in light of advancements in technology and business practices that have dramatically improved

processing and settlement capabilities. Payor institutions today clearly are able to process and settle checks received later than 10 a.m. on the day of receipt. Indeed, the Federal Reserve's move to noon presentment has not resulted in significant operational problems for payor institutions. In this regard, several clearinghouses have also moved their presentment times to later in the morning without encountering operational problems.

Further, any cost that the payor institution incurs in paying a check that has been presented to it for payment should normally be borne by the payor institution or its customer, the person who wrote the check. We can find no justification for transferring these costs, through a presentment fee, to the collector and ultimately to the payee of the check. In addition, transferring these payor institution costs to the collecting bank and payee eliminates the payor institution's incentive to minimize these costs, thus undermining the market discipline that helps to assure that the costs of effecting payments will be minimized. Finally, since presentment fees are not imposed uniformly, they encourage inefficient collection arrangements as collecting institutions distort their check collection patterns in order to avoid presentment fees.

26. The Congress has an interest in making the proceeds of government checks available to consumers more rapidly. Most, if not all, banks find it virtually impossible to receive these items in a deposit, transport them to a processing center, encode, prove, microfilm, endorse, package and transport them to the local Reserve Bank before the established cutoff hour (3:00 p.m. in New York). Why, in the interest of consumer availability, cannot the Reserve Banks accept such items until 6:00 p.m. or later? We note that the Federal Reserve has excercised its prerogative to push back the cutoff hour for its presentments to other banks.

The Federal Reserve collects Treasury checks as fiscal agent of the U.S. Treasury. The cut-off hour for deposit of U.S. Government checks is established for the Federal Reserve by rules of the U.S. Treasury. Treasury rules require that all Treasury checks must be physically received by the Federal Reserve no later than 4:00 p.m. local time for the charge to be recorded that day. The Treasury rules further provide that actual time may be earlier at the option of the Reserve Bank. Currently, Federal Reserve offices have established cut-off times between 3:00 p.m. and 4:00 p.m for the receipt of U.S. Government checks. Consequently, in order to change the cut-off hour to 6:00 p.m., the Treasury would have to change its rules. We will discuss this matter with the Treasury.

27. If the private sector successfully develops an efficient electronic funds transfer system which meets the needs of the public, will the Federal Reserve continue to compete in providing that service? If so, why?

The Federal Reserve provides electronic funds transfers to all depository institutions throughout the country in the form of Automated Clearing House and wire transfer services. We are constantly reviewing our service offerings to ensure that they contribute to the efficiency of the nation's payments mechanism and to the safety and soundness of our financial system. If the private sector develops an efficient electronic funds transfer system, the Federal Reserve would evaluate the desirability of continuing its own electronic funds transfer services. Such a review would take into account the desirability of preserving alternative systems, the effect that new systems may have upon the efficiency of the payments mechanism and on the integrity of the nation's financial system, and the need to provide an adequate level of services to all the nation's depository institutions. Based upon an evaluation of these factors, the Federal Reserve would then determine whether it is in the public interest not to continue to offer such services to the nation's depository institutions.

In this connection, it should be stressed that one critical feature of the Federal Reserve's funds transfer system--particularly as it applies to large dollar payments--is that payments are "final" when received. Private alternatives, of which there are several, rely on some form of end of day settlement by the Federal Reserve, which can result in greater risks in the overall payments system. Any decision, however far into the future, would have to weigh very carefully these risk considerations.

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28. Prior to the August 1983 implementation of one day delayed availability on interdistrict return items, the Federal Reserve determined that $130 million in daily float was attributable to return items. A representative of the Federal Reserve has since indicated that the assessment of availability deferred exceeds the actual loss of availability by approximately $7 million daily. How is this credit float utilized? Perhaps the return item availability assessment should be less than one day.

Prior to August 1983, float was generated on returned checks where the payor institution and the institution of first deposit were located in different Federal Reserve office territories ("interterritory return items") because credit was given on the day that such checks were received at a Reserve Bank and at least one day was required to transport them to the Federal Reserve office of the bank of first deposit. To eliminate this float, the Reserve Banks now defer credit on interterritory return items one day. Same-day credit is provided on intraterritory return items when received in separately sorted cash letters. However, many depository institutions choose not to separate their intra and interterritory returns, and to accept a one day deferment of credit on all of their returned checks. As a result, the Reserve Banks are currently experiencing a small amount of credit float in their return item operations.

In order to eliminate this small remaining credit float, the Federal Reserve is investigating the feasibility of calculating availability on a check by check basis. That is, providing a one day deferral of credit for interterritory returns and same-day credit for intraterritory returns, regardless of whether the checks are separately sorted by the depository institution.

29. During 1983, the Federal Reserve System implemented a number of actions to price float in the check collection system (see attachment). Approximately $1,250 million in float resulting from interterritory transportation, return items and nonstandard holiday closings was "eliminated" by new credit deferral procedures. Approximately $350 million in float resulting from FRS holdover, intraterritory transportation and other sources was priced at the federal funds rate and added to the cost base for check collection services. The remaining $160 million resulting from mid week closings was valued at the federal funds rate and charged to those institutions closed mid week. Are not these actions merely accounting procedures through which float has been replaced by deferred credits and added costs to check collection service? Don't these procedures and their results draw attention away from the problem of speeding up the collection process? As a result of these accounting procedures, what are the present average daily deferred credits resulting from interterritory transportation, return items and nonstandard holiday closings? What are the individual costs, and the federal funds rate used in deriving those costs, that are added to the check collection system for holdover delays, interterritory transportation delays and other check handling delays?

The Monetary Control Act of 1980 (MCA) requires the Federal Reserve to charge for Federal Reserve float remaining after operational improvements to reduce float. After passage of the MCA, the Federal Reserve initially determined to intensify its then-existing float reduction efforts by implementing operational improvements with high benefit/cost ratios to speed the collection of checks. Such operational improvements that were implemented included restructuring the interdistrict transportation system, adding processing equipment, rearranging labor resources to conform more closely to incoming deposits of checks, supplementing staff where necessary, and in general streamlining internal processing procedures.

Each of these operational improvements accelerated the collection of checks by shortening the time period between when checks are deposited with the Federal Reserve and presented for payment to payor institutions. These operational improvements by the Federal Reserve have dramatically

reduced the daily average amount of Federal Reserve check float from $4.5 billion in 1980 to $1.2 billion in the fourth quarter of 1983. We are continuing to explore methods to speed up further the collection of checks and plan to implement such improvements when cost effective.

Given the MCA's float pricing requirement, the Federal Reserve has implemented a series of actions to eliminate or price the float remaining after the operational improvements that accelerated the collection of checks. These actions included: (1) changing crediting procedures for interterritory check deposits; (2) changing the crediting procedures for interterritory return items; and (3) incorporating the value of any residual float into the check collection cost base.

Of the $1.2 billion daily average float in the fourth quarter of 1983, approximately $500 million was recovered through "as of" adjustments and explicit fees. The cost of approximately $700 million in "residual" check float, the value of which was calculated at the daily average federal funds rate for the applicable month, was added to the cost base subject to recovery through per-item fees.

The combination of steps taken by the Federal Reserve were by no means "accounting procedures" which divert attention from the need to speed the collection of checks. Simultaneous efforts to speed check collection have been made and other such steps may be forthcoming. Most importantly, however, the approach taken by the Federal Reserve in reducing and/or pricing float sought--to the maximum extent possible in the time-frame available--to place the burden of the adjustment on those who benefited from float and to avoid new incentives for still others to benefit from float. As to the "awareness" problem, I can only suggest that my experience in talking to people within the Federal Reserve and in the private sector suggests that sensitivity levels regarding float are at an all time high.

The CHAIRMAN. Next we do have a panel composed of Mr. Christopher J. Murphy III, president and chief executive officer, First Source Bank, South Bend, Ind.; on behalf of the American Bankers Association; and O. J. Tomson, president, Citizen's National Bank, Charles City, Iowa; on behalf of the Independent Bankers Association of America.

Gentlemen, we are happy to have you with us today and, Mr. Murphy, if you would like to begin.

STATEMENT OF CHRISTOPHER J. MURPHY III, PRESIDENT AND CHIEF EXECUTIVE OFFICER, FIRST SOURCE BANK, SOUTH BEND, IND.; ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION

Mr. MURPHY. Thank you, Mr. Chairman.

[The complete statement follows:]

TESTIMONY OF THE
AMERICAN BANKERS ASSOCIATION
BEFORE THE
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
OF THE
UNITED STATES SENATE
ON THE
GENERAL ACCOUNTING OFFICE DRAFT REPORT
ON
"FEDERAL RESERVE SYSTEM PRICING OF CHECK CLEARING ACTIVITIES"

APRIL 11, 1984

Mr. Chairman and members of the Committee, I am Christopher J. Murphy, III, President and Chief Executive Officer, First Source Bank, South Bend, Indiana. I am representing the American Bankers Association in my capacity as the Vice Chairman of the Association's Payment Systems Policy Board.

The Association membership consists of over 90% of the approximately 14,500 full-service banks in this country. The combined assets of our nearly 13,000 member banks represents approximately 95% of the industry total. Our members represent all different sizes of banks. However, approximately 90% of our members can be described as community banks having assets of $100 million or less.

The American Bankers Association welcomes this opportunity to comment on the March 16, 1984 draft of the proposed report of the General Accounting Office on "Federal Reserve System Pricing of Check Clearing Activities." The Association has maintained a close and active interest in the subject of Federal Reserve pricing since 1978. Through the work of its Pricing Task Force, including studies by outside consultants, the Association has sought to make constructive contributions to the dialogue

on Federal Reserve pricing prior to the passage of the Monetary Control Act of 1980. Since the passage of the Act, the Association has responded to all opportunities for comment on Federal Reserve pricing proposals and for testimony before Congressional committees. The consistent position of the Association throughout this period can be summarized as follows:

1. Payments system services provided by the Federal Reserve System have, and continue to benefit, the financial industry.

2. Priced services at Federal Reserve Banks should be accessible to all depository institutions offering transactions accounts, regardless of size and geographic location.

3. Federal Reserve services should be priced explicitly.

4. Prices should be sufficient to cover the full costs of each type of service plus a "mark-up" equal to capital costs and taxes incurred by private sector providers of payments services.

5. Any decreases in the volume of services provided by Federal Reserve Banks should be matched by reductions in resources committed to the production of such services, or allocation of higher unit costs to pricing considerations.

6. A program to reduce Federal Reserve float should be implemented, and float should also be priced.

7. The role of the Federal Reserve in the provision of payments services should be circumscribed by guidelines based on pricing principles which recognize that the Federal Reserve is a unique government agency. The Federal Reserve is the regulator of the payments system, is not subject to the same market disciplines as private sector competitors, and could exercise a dominant "market-power" position in the market for payments services.

Subsequent to these conclusions, the Association has maintained that significant benefits have been derived from the participation of the Federal Reserve Banks in the payments services market. These benefits have been shown in increased competition for market share resulting in higher quality of service to the industry. The problem which continues to face us, however, is how to assure that the results of the Federal Reserve's enhanced participation can be balanced with assuring the health of a competitive private sector.

Turning to the March 16, 1984 draft of the proposed report of the U.S. General Accounting Office on "Federal Reserve System Pricing of Check Clearing Activities," the Association commends the GAO on its study. The GAO has obviously made a major effort to be responsive to the requests for information set forth in the April 6, 1983 letter of the Senate Committee on Banking, Housing and Urban Affairs. In its proposed report and, especially, in the report's appendices, the GAO has provided a great deal of information which was not previously available. Previously, many competing providers of check services have expressed frustration at their inability to make cost comparisons with Federal Reserve offerings. The amount of information made available by the Federal Reserve pertinent to the costing and pricing of its services has created a problem in acceptance by private sector competitors of the Federal Reserve's approach to pricing. The GAO's report makes an important contribution to the correction of that problem.

The proposed report contrasts sharply with the 1982 GAO study of Federal Reserve check clearing activities. The report confirms that the Federal Reserve has made significant strides in its efforts to comply with the Monetary Control Act, particularly in the float and full cost recovery areas.

Our statement will focus mainly on points where we do not agree with the interpretations and conclusions in the GAO's proposed report. We will comment on needs for additional information and evaluation. In making this statement, we are not seeking to criticize the work of the GAO, for which we have the highest regard, but to contribute in a constructive way to the continuing dialogue on the Federal Reserve's approach to the pricing of its services.

Private Sector Adjustment Factor

From the inception of its pricing program, the Federal Reserve has tended to minimize the amount of the Private Sector Adjustment Factor (PSAF). Confirmation of this conclusion is found in the statements in the GAO's report, to the effect that the Federal Reserve's proposed PSAF for 1984 is at the low end of the range regarded as acceptable by the GAO.

Minimization of the PSAF is widely perceived by correspondent bank competitors as evidence of the Federal Reserve's assumed intent to undercut private sector providers of check clearing services. As reported by these competitors, such perception tends to discourage private sector providers from making the capital investments needed to maintain their positions in the market for check clearing services. Especially in view of the Federal Reserve's dominant market position, the long-term implications of minimization of the PSAF would be adverse to the viability of private sector competitors, and contrary to the Monetary Control Act of 1980, which clearly contemplated the maintenance of private sector alternatives to the Federal Reserve in the market for payments services.

While finding that the Federal Reserve's calculation of the PSAF for 1984 is at the low end of what the GAO regards as the acceptable range, the essential conclusion in the GAO's report is that the PSAF resulting in an apparent after-tax return of 13.7% on equity capital is "not understated."

The acceptable range for after-tax return on equity capital is defined by the GAO as 13.0% to 15.4%. In our letter of December 20, 1984 (Docket No. R-0485), the Association seriously questioned the choice of 12 bank holding companies as the relevant model. (A copy of the letter is included as an attachment to this statement). We observed that the capital structure and earnings performance of such companies are dominated by

activities other than the provision of priced services to other banks. We believe that the recently approved approach using the 25 largest bank holding companies is an improvement, but hardly a perfect model. Several of the holding companies included do not constitute competitors offering competitive check clearing services. Moreover, the total business of these holding companies is not coincident with the Federal Reserve System's check clearing business. The GAO report does not make an affirmative case for the use of "recent past performance of the 25 largest bank holding companies" as the basis for defining an acceptable range for the PSAF. Rather, the GAO's choice appears to rest on an argument rejecting data processing firms as the appropriate model. However, as stated in our December 20, 1983 letter, the dissimilarity between the services provided by the Federal Reserve and the totality of services provided by bank holding companies and their subsidiaries is far greater than the dissimilarity found between Federal Reserve services and the types of services provided by nonbank data processing companies.

The Federal Reserve is a unique organization engaged in an unusual government exercise of providing services where the clear intent of the Congress was that there should be no subsidy to users, that expansion of private sector competitors should not be discouraged, and that new entry and innovation from the private sector should not be forestalled.

The Association recommends the following guidelines for the calculation of the PSAF:

1. The calculation of the PSAF should be based on the well established approach to capital budgeting used in the evaluation of alternative investment opportunities. The approach should incorporate the factors which a private firm would take into consideration in deciding whether or not to expand existing check clearing services or to enter the check clearing business.

2. As suggested in one or more alternative calculations found in Appendix X of the GAO's report, the balance sheet pertinent to the calculation of the PSAF should be expanded to include recognition of asset and/or liability items related to float, clearing balances, and leases.

3. The Federal Reserve should make adequate disclosure of methods used to allocate assets jointly used for priced and nonpriced services. Without such disclosure, there is no basis for any opinion about whether or not there is an underallocation of joint-purpose assets.

4. Operating costs should include all expenditures related to the production of priced services, including such contract services as transportation.

Application of these guidelines would help eliminate much of the controversy about the PSAF, and facilitate decisions private sector competitors would make concerning expanding or entering the check clearing business.

Presentment Fees

The GAO's report confirms that the Federal Reserve does have a competitive advantage in its statutory exemption from presentment fees. The exemption has a direct effect on Federal Reserve costs relative to private sector competitors, which results in enhancing market advantages of the Federal Reserve as the dominant supplier of check clearing services.

The statutory exemption of the Federal Reserve from presentment fees appears to be outmoded. The legislative history of the exemption, which was pertinent to the long-since resolved issue of par clearance of checks, does not seem to justify retention of the exemption.

While observing that subjecting the Federal Reserve to presentment fees has merit "in principle", the GAO's report expresses concern that repeal of the exemption might expose the Federal Reserve to discriminatory presentment fees. The Association believes that such concern is misplaced.

The Federal Reserve has considerable power of an informal nature to protect itself from discriminatory charges. Moreover, the Federal Reserve enjoys the protection of Federal antitrust laws.

In a period when deregulation of prices in banking has brought many adjustments for private sector competitors, it is not credible to believe that an agency as powerful as the Federal Reserve cannot cope with deregulation in the form of repeal of the exemption from presentment fees. There is no basis for believing that repeal of the exemption would result in the "administrative problems" implied by the GAO's questions about what would ensue after such repeal. The workings of the marketplace will determine what will happen if the exemption is repealed, just as the marketplace has determined the results of deregulation of bank prices in general.

The Association recommends that the statutory exemption of the Federal Reserve from presentment fees be repealed.

Flexible Pricing

The GAO's discussion of the "Federal Reserve's flexible approach to pricing individual services" is of particular interest. The GAO confirms that full recovery of costs is not being effected in certain Federal Reserve Districts, and for certain lines of service within Federal Reserve Districts. As indicated in the early part of this statement, one of the key points in our support of pricing has been that Federal Reserve prices should be sufficient to recover the full costs of each line of service, plus a "mark-up" equal to the capital costs and taxes incurred by private sector providers of payments services. It is a matter of concern that this important condition of competitive fairness be applied both by line of service, and geographically by Federal Reserve District.

The GAO's report has characterized the Federal Reserve's approach as "flexible" and saying that such flexibility in pricing is "typical of business." Any private sector competitor which operates on a nationwide basis, accounted for 40% of the market for its services, was twenty times the size of its next largest competitor, and engaged in the kind of "flexibility in pricing" described by the GAO report would be charged with price discrimination and almost certainly find itself in constant litigation with damaged competitors.

It's difficult to accept the GAO's rationalization that it would be cumbersome to administer a requirement that each price be based only on the costs of providing that particular service. It's also difficult to accept the observation that the problems of allocating fixed and joint costs are too formidable to permit pricing to recover full costs on each line of service.

If the Federal Reserve were a minor participant in the market for payments services, its ability to engage in discriminatory pricing would be severely limited by market forces. However, because the Federal Reserve is such a dominant participant in the market, it should take great care not to disturb viable private sector competition. In order to assuage concerns of private sector competitors, the Federal Reserve System must continue dialogue on market and pricing questions with those who participate in offering check clearing services to the industry.

Recovery of Transportation Costs

The GAO's report notes that there are significant deficiencies in the Federal Reserve's data on transportation costs.

The Federal Reserve is not seeking to recover actual transportation costs for each type of service within each Federal Reserve district.

Instead, the Federal Reserve is apparently setting its charges for transportation on a "competitive basis" in each market and then distributing transportation costs in a proportional way according to the revenues received by type of service for the System as a whole. Some of our members see this approach as a potential for pricing selectively, on a geographic basis.

Although the GAO states that "we agree that the way the Federal Reserve prices its services can pose a problem for private sector courier firms that do not have Federal Reserve contracts," the GAO assserts that "the apparent remedy — requiring the transportation surcharge to exactly cover costs for each market area -- would be difficult to administer, is not required under existing law, and would not necessarily be effective." We believe that the difficulty of administering a proper cost allocation system has been exaggerated and a more equitable means can be found.

The GAO's report shows that the Federal Reserve did not recover transportation costs in 1982 and 1983. In addition, the GAO's description of the reconfiguration of the Interterritory Transportation System in 1982, the move to noon presentment in 1983, and the delay in imposing new ITS surcharges until the move to noon presentment was underway, suggest that the costs of ITS was justified by a presumption that the Federal Reserve would capture a larger share of the "rapid availability" market: higher value items cleared beyond local areas.

Market Share

The GAO's report observes that the volume of checks handled by the Federal Reserve declined by about 10% after pricing was initiated in 1981 but appeared to be on a rising trend in 1983. The GAO surmises that the market share of the Federal Reserve may still be declining as the relative

gain in 1983 was less than the expected rate of increase in the total number of checks processed nationally. As correctly noted by the GAO, estimations of market share are largely guesswork. Comprehensive data on check clearings are not available, and data which are available involve some ambiguities. For example, any particular check may be handled by both the Federal Reserve and a private sector provider of check clearing services.

We believe that the loss of volume by the Federal Reserve after the inception of pricing in 1981 was largely due to flow of some volume to local clearinghouse associations. Many local clearinghouse associations had lapsed into inactivity after the Federal Reserve expanded its check clearing facilities in the 1970's through the establishment of the Regional Check Proessing Centers (RCPC's). With the advent of pricing, a number of local clearinghouse associations again became active. Gains in Federal Reserve volume in 1983 were probably not at the expense of local clearinghouse associations but rather at the expense of individual banking organizations engaged in the business of clearing checks, i.e., the private sector competitors of the Federal Reserve.

The Association believes that the basic issue affecting Federal Reserve pricing is what market share the Federal Reserve has or should have, or aspires to have in the markets in which it competes. We expressed this opinion in our letter of December 20, 1983 to the Federal Reserve on Docket No. R-0485.

If the expectation of the private sector is that the Federal Reserve will use its substantial resources and power to increase its market share, then private sector competitors will curtail expansion plans and perhaps

even pull out of the market. New competitors will not enter, and innovation by the private sector will be discouraged.

We recommend that the Federal Reserve issue a policy statement indicating its long-term intentions with respect to its share of the market for check clearing services. Comment from interested parties should be invited to develop an "accord" on the role that the Federal Reserve should play in the market for payments services, including, if possible, guidelines for the market shares which the Federal Reserve would seek to maintain in various services lines.

The American Bankers Association commends the GAO on its study of "Federal Reserve System Pricing of Check Clearing services." In focusing on points of disagreement with certain conclusions in the GAO's report, the Association is not seeking to criticize the GAO but rather to express differences in the interpretation of data and in conclusions based on different interpretations and points of view.

Summary

1. Significant benefits have accrued to the financial services industry from the participation of the Federal Reserve System in the payments systems market.

2. The Federal Reserve System has made significant strides towards compliance with the Monetary Control Act of 1980 since the last GAO review in 1982.

3. The Association finds in the GAO's report confirmation that the Federal Reserve has minimized the PSAF.

4. The statutory exemption of the Federal Reserve from payment of presentment fees is outmoded, and the Association recommends repeal. While finding merit in such repeal "in principle," the GAO expresses concern about possible discriminatory treatment of the Federal Reserve by banks charging presentment fees. We believe that such concern is unfounded.

5. The Federal Reserve should make full recovery of transportation costs, and to allocate such costs by service line within each Federal Reserve district.

6. It is essential to the maintenance of viable private sector alternatives that the Federal Reserve publish a policy statement concerning its long-term intentions relative to the market shares it intends to pursue in its various service lines. This policy statement should be exposed to public comment, and an attempt should be made to formulate an "accord" about the future role and relative position of the Federal Reserve in the market for payments services. We acknowledge that the Federal Reserve has constructed such a dialogue over the past two years.

The Association appreciates the opportunity provided by this Committee to comment on the GAO's report. We will respond to any questions relative to the GAO study raised by the Committee, either orally or subsequently in writing.

AMERICAN
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EXECUTIVE DIRECTOR
GOVERNMENT RELATIONS

Gerald M. Lowrie
202/467-4097

December 20, 1983

Mr. William W. Wiles
Secretary
Board of Governors of the
Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D. C. 20551

Re: Docket No. R-0485

Dear Mr. Wiles:

The American Bankers Association appreciates the cooperation of the Board of Governors in supplying certain additional information which we requested, and to extend the deadline for comment on Docket No. R-0485. Our comment will be directed first to the specific issues posed in Docket No. R-0485, and in addition, we wish to make a general comment on what we perceive as the fundamental issues in the pricing of Federal Reserve services.

The Private Sector Adjustment Factor

a. Choice of Model.

We believe that expansion of the sample to include the 25 largest bank holding companies is an improvement over the previous sample of 12 companies. However, we would point out that 6 of the 25 companies (Irving, Bank of New York, Marine Midland, Citicorp, J.P. Morgan, and Bankers Trust) do not perceive themselves as engaged, to any significant extent, in providing to other banks the types of services which the Federal Reserve now provides on a priced basis. Our information is based on telephone contacts with the companies included in the sample. Moreover, the sample does not include a number of regional banking organizations which are substantially engaged in the provision of check collection services to other depository institutions.

More fundamentally however, we seriously question whether the choice of bank holding companies as the model is appropriate. The capital structure and earnings performance of such companies are dominated by activities other than the provision of priced services to other banks. Although the Board has twice rejected nonbank data processing companies as the model, we urge that the Board's decision be given further reconsideration. The dissimilarity between the services provided by the Federal Reserve and the

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totality of services provided by bank holding companies and their subsidiaries is far greater than the dissimilarity found between Federal Reserve services and the services provided by nonbank data processing companies. For example, Docket No. R-0485 states that none of the six nonbank data processors which are included in the Federal Reserve's review had mentioned the Federal Reserve as a competitor in their 1982 Form 10-K's. Did the Federal Reserve also review the 10-K's of the 25 largest bank holding companies to see how many mentioned the Federal Reserve as a competitor?

The essential point, however, is that the Federal Reserve is a unique organization engaged in an unusual government experiment of providing services where the clear intent of the Congress was that there should be no subsidy to users. The Monetary Control Act of 1980 specifically requires full recovery of costs, including the PSAF. The Federal Reserve should be concerned with the question of whether or not it is in full compliance with Congressional intent that there should be no subsidy to users. In our view, the use of the bank holding company model leaves that question open to further debate and contention.

b. Long-term Assets

The American Bankers Association has not yet received the breakdown of assets which we requested from the Board in our letter of November 16, 1983 (item 5). We continue to be interested in learning (a) the dollar value of assets identified under PACS as single-purpose assets used in the production of priced services, (b) the dollar value of assets identified under PACS as joint-purpose assets, and (c) the proportion of such joint-purpose assets actually allocated to priced services. However, we must say that the Association was not previously critical of the use of the expenses-ratio method of allocating long-term assets. Based on our knowledge of the types of space used for the production of priced services, we were reasonably confident that the expenses-ratio method did not result in an underallocation of long-term assets to priced services. Now, though, we have no basis for forming even an impression of whether or not the direct determination method results in an underallocation. The breakdown which we have requested might enable us to form an opinion.

We also note that the proposal indicates that some priced-services space is used 24 hours a day. This raises questions about how PACS allocates such expense items as depreciation, repair and maintenance, cleaning services, utilities, security, food service, employee parking costs, etc. We presume that the direct determination method implies that the 24-hour nature of the operations for priced services should be taken into account in allocating certain overhead expenses, but question the capability of PACS to provide that type of allocation.

c. Tax Rate.

The Association believes that the tax-rate used in the PSAF should be the maximum Federal rate on corporate income plus a weighted average of the maximum state tax rates on corporate income. Our position reflects our view that private sector decisions to expand facilities competitive with the Federal Reserve, or to enter into competition with the Federal Reserve, are based on projections using maximum tax rates. That is, the return from private sector investment would be calculated as an increment to income, subject to maximum tax rates. In the long run, the basic mechanism that brings competitive markets into equilibrium is the entry and exit of firms. The use of an average tax rate by the Federal Reserve may well have an adverse effect on entry and expansion of private sector competitors, thereby stultifying the basic modus operandi of competitive markets.

As the inclusion of deferred taxes in the PSAF calculation moves the tax rate closer to the maximum, we favor that proposal. But we continue to recommend that the Federal Reserve use maximum tax rates in the calculation of the PSAF.

d. Date for Asset Base Estimate.

We concur in the proposal to use the upcoming year in the PSAF calculation, since this procedure is consistent with private sector budgetary practices.

e. Sales Taxes.

We also concur in the proposal to include sales taxes, since this procedure is consistent with private sector methods.

f. Board of Governors Assets and Expenses.

Again, we concur in this proposal, as its logic is evident.

g. Shipping Expenses.

We recommend that shipping expenses be included in the calculation of the PSAF. It is our understanding that certain allocations of joint-purpose assets continue to be made on an expense-ratio basis. Therefore, we cannot accept the explanation on page 7 of Docket No. R-0485 to the effect that inclusion of shipping expenses would not result in any increases in the recoveries under a PSAF that would include shipping expenses. The Federal Reserve should put an end to the contention over inclusion of shipping expenses by including them, whether the effect is to increase recoveries or leave them unchanged.

h. Leased Assets.

The Federal Reserve should conform to generally accepted accounting standards in the capitalization of leases. We believe that the "double-counting" argument on page 8 of Docket No. R-0485 is ill-founded, as it implies that the Federal Reserve should not conform to private sector accounting practices.

i. Book Value of Physical Assets.

Consistent with its position that the Federal Reserve should conform to private sector accounting practices, the Association concurs in the view that book value, not market value, is the appropriate valuation of fixed assets. However, the Federal Reserve should recognize that certain of its fixed assets had been depreciated over a long period prior to the beginning of pricing in 1981. The interests of the Treasury would have been better served if in 1981 the fixed assets of the Federal Reserve used in the production of priced services, had been revalued on the basis of replacement costs. That is, the advent of priced services might well have been treated as a de novo situation, with a view to recapturing for the Treasury some of the revenues foregone during the years when Federal Reserve services were not priced.

j. Short-term Assets.

We generally concur with the approach proposed on short-term assets. However, we object to the method used to estimate the cost of the short-term debt supporting such assets. We understand that the cost is derived from interest expenses reported by the sample bank holding companies on negotiable CD's, other time deposits, Fed funds, commercial paper, and other purchased funds. This approach assumes that the internal cost of short-term funds allocated to a fee producing activity in a bank holding company is the same as the external cost, and that assumption is erroneous. The cost of funds should, at least, be marked up by the internal costs associated with obtaining the funds. The relevant internal cost from the point of view of economic analysis is opportunity cost, and since the Federal Reserve has an obligation to foster competitive markets, economic analysis is pertinent. The relevant opportunity costs would appear to be the yield received by banking organizations on short-term loans. We recommend that the cost of short-term debt included in the PSAF be the New York prime rate.

k. The Cost of Equity.

We believe that the Federal Reserve continues to underestimate the cost of equity. Return on book value of equity is not the appropriate measure, because it does not reflect marketplace valuations. The proposal does not

explicitly state the after-tax return on equity included in the PSAF, but the proposed 1984 pre-tax rate and the proposed 1984 tax rate imply an after-tax return of 13.64 percent. Information obtained from Value Line Investment Service shows that the simple average of the earnings-price ratios of the 25 largest bank holding companies was 15.6 percent according to reports published in October-November 1983. It is standard practice in calculating cost of capital to add a growth factor to observed costs as well as add an estimate of the transaction costs of obtaining new capital. We think that a conservative estimate of after-tax cost of equity would be at least 18 percent. Using the Federal Reserve's proposed tax rate, the pre-tax equity rate would then be close to 28 percent, instead of 21.25 percent. We urge a thorough reconsideration of the calculation of cost of equity, drawing upon standard approaches used in financial analysis.

General Comment

We were disturbed by the following statement on page 1 of Docket No. R-0485: "Over time, however, the pricing process more generally should seek to ensure that economic resources are allocated and payments services are provided in the most efficient ways possible." The context of this assertion appears to imply that the Federal Reserve believes that it has some sort of Congressional mandate to substitute the Federal Reserve's judgment for the workings of the marketplace. We have taken issue with this apparent presumption of the Federal Reserve in previously submitted comments on pricing issues. We do not find any mandate in P.L.96-221 for the Federal Reserve to impose on the marketplace its judgments about efficiency. On the contrary, we believe that the intent of P.L.96-221 was deregulation to give greater freedom to market forces.

The task given the Federal Reserve by P.L.96-221 is a difficult one — how to price Federal Reserve services and foster competition. Earlier in this comment, we observed that the essential mechanism of competition is entry and exit of firms. As the payments services business is a growing one and is affected by important technological changes, entry of new firms and expansion of existing firms would be a reasonable expectation. However, the Federal Reserve could thwart such entry and expansion in the private sector.

The basic issue, as we see it, is not the PSAF as such. Rather the issue is what market share the Federal Reserve has or should have, or aspires to have in the markets where it competes. If the expectation of the private sector is that the Federal Reserve will use its substantial resources and regulatory power to increase its market share, then private sector competitors will curtail expansion plans and perhaps even pull out of the

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market. New competitors will not enter, and innovation by the private sector will be discouraged. The PSAF can be regarded as a signal of the Federal Reserve's intent. Thus far, the PSAF appears to be signaling an aggressive expansion posture by the Federal Reserve.

In our comments to pricing proposals as far back as 1981, or even communications to the Board in 1980, the Association stressed the need for a set of pricing principles which would foster, not discourage, private sector competition. Over the past two years or so, it has become evident that an appropriate set of pricing principles would be very difficult, if not impossible, to develop. We now believe that what is needed is a set of guidelines concerning the market share which the Federal Reserve should seek to have to support its responsibilities in the payments system. Should the Federal Reserve seek to decrease its market share, maintain it at a constant level, or increase? A reasonably clear answer to that question would be useful to the private sector in planning its future investments in the payments system.

Sincerely,

Gerald M. Lowrie

Gerald M. Lowrie

The CHAIRMAN. Thank you, Mr. Murphy.
Mr. Tomson.

STATEMENT OF O. J. TOMSON, PRESIDENT, CITIZENS NATIONAL BANK, CHARLES CITY, IOWA; ON BEHALF OF THE INDEPENDENT BANKERS ASSOCIATION OF AMERICA

Mr. TOMSON. Chairman Garn, and members of the Senate Banking Committee, my complete statement has been submitted for the record so I will try to abbreviate it here.

It is a privilege to appear before this committee to offer testimony on the Federal Reserve pricing of check clearing activities. My name is O. J. Tomson, and I serve as president of the Citizens National Bank of Charles City, Iowa. This is a $50 million bank located in a community of approximately 9,000 people in northeast Iowa. I'm serving today as a representative of the Independent Bankers Association of America, and as such, I serve as a spokesman for the 7,000-plus member banks of our organization who, by and large, are the smaller community banks located throughout suburban and rural America.

Perhaps I should mention that I am a class A director of the Federal Reserve Bank of Chicago, but I have no authority nor do I speak in any way for the Federal Reserve System today. I am here strictly as the representative of the IBAA.

The vast majority of community bankers view the Fed's role in the payments system as essential, continuing, and extremely important to the ongoing stability and improvement of this very significant aspect of the financial framework of our Nation. The dollar volume of checks cleared through the Federal Reserve System's regional banks and related facilities in 1983 exceeded $8.4 trillion, and in volume this represents nearly 13 billion processed items. And this only represents a segment of the total, with the balance being cleared through the correspondent bank network.

When the Federal Reserve Act became law in 1913, Congress specifically requested that the System establish a nationwide check clearing network to eliminate inefficient payment practices and promote the payment of checks at par value. While it has over the years attempted to do this, the charge from Congress as set forth in section 107 of the Monetary Control Act of 1980 made a much more explicit directive to the Fed than had existed prior to that time. The 1980 act also served to enlarge the Fed's constituency and established the phase-in of universal reserves, making the differentiation between membership and nonmembership in the system a rather meaningless distinction.

POSITIVE RESULTS OF THE 1980 ACT

For those of us who are country bankers, the mandates of the 1980 act were most positive because they caused the Federal Reserve System to reevaluate its role as a provider of services. We felt that the System for too many years had been oriented toward serving the needs of the very large banks in this country and we felt that it had become stuffy and that it really did not cater to the needs of the small banks of this Nation, and I think if you look back at the operating circulars that existed prior to the 1980 act you would see that the small banks really had no opportunity to patch their checks together in the way we had to do to comply with the Federal Reserve System. So by and large, the act gave us an opportunity to use the services of the Fed to a greater degree than we had previously to that time.

So the Fed, with a greatly enlarged constituency, including 40,000-plus financial institutions in the Nation, saw a new era ushered in. The Fed focused on its expanded market as it was directed to do by Congress and set out to meet the goals and objectives of the Monetary Control Act.

You might ask, why do community bankers view the actions of the Fed in a positive way and why do we buy their services when we have the alternative of going to the private sector? Because after 70 years under the Federal Reserve Act, we still see abuses being promulgated by the private correspondent banks, and practices being continued, and inefficiencies being encouraged and marketed, which we feel are contrary to the public good.

For example, the community banks of this Nation are by and large collector banks. The vast majority of us are geographically remote from the Federal Reserve or correspondent depository facilities and must rely daily on both ground and air transportation to present remittance letters for collection. Our customers are the victims of the so-called controlled disbursement tactics of the

money center banks who have taught the corporate treasurers so well the profit opportunities available to their respective companies by drawing their firms' checks on branches of these large banks rather than our own that are conveniently located 1 day outside of a money market clearinghouse. Geographically, this may only be 1 mile outside a RCPC immediate credit facility, but nevertheless the situation exists. And, of course, the correspondent bank also obtains the benefits of those delaying tactics.

We don't necessarily fault the large banking competitors for trying to make money. They are in business for that purpose. And that's what we're in business for—to make a profit. But we are not inclined to relegate ourselves into relying entirely upon a correspondent, who may be a formidable competitor. He may be going up and down the street soliciting our deposits and our own business, or using the media in our communities to get this same business, to sell to us such a significant aspect of the services we are required to purchase because of the nature of our business.

So we need a viable alternative source where we can purchase needed services and this is what the Federal Reserve Act authorized, and what the Monetary Control Act of 1980 reaffirmed.

SOME BASIC ARGUMENTS FOR THE FED'S CONTINUED PRESENCE

I have set out some of the basic arguments for the Fed's continued presence in my paper which has been submitted and these have been covered earlier. I think what we're really discussing is whether the Fed, in the pricing of its check clearing services, is competing fairly with the private sector?

To answer this adequately presumes a lot of knowledge on the part of persons providing the answer. It does appear, and the recent report from the General Accounting Office affirms, that the Fed is doing a very conscientious job of internal cost accounting, of improving its accounting techniques with time, and attempting to properly allocate overhead. The pricing control system and the tax system that the Fed uses has been in place since 1977 and it's being refined as time goes along. Pricing and reduction of float came about simultaneously. This is being digested—has been over the past 36 months, and again, refinements have been made.

Regarding clearing balances, it's evident, at least in our bank, that we have an advantage when we're dealing with the Fed because we get a higher earnings credit, and they haven't had to use a reserve reduction where a private sector correspondent has had to. This is being corrected and I understand that in 1984 this advantage will have evaporated.

The private sector adjustment factor—it's difficult I think for a country banker to say how this should be calculated. We look at perhaps a 15-percent return as being a fair and equitable return in a rural environment to small businesses. Certainly they are entitled to something beyond what they could get in the relatively risk-free instruments that are available in the marketplace today. The GAO I think has looked at this. The Fed has enlarged its data base from 12 to 25 correspondents and is trying to do what we think is a fair comparison of what its return ought to be in relation to the

types of businesses that it is competing with, and I don't know what more could be asked of them.

One thing we might take issue with the GAO on was their statement that prior to 1980 the check clearing services of the Fed were free. I don't recall that they were ever free. When we remember we had to leave large reserve balances lying on the table—in our case, we had $800,000 or $900,000 lying there without getting anything in return for it—we much prefer the system as it is today. In fact, had it not been changed, we would not be a member of the Federal Reserve System today. It was too expensive to belong.

Flexibility was another question that was raised, as to whether or not the Fed can be as flexible, or is as flexible, or is able to be as flexible, in its pricing as the private sector can. And I question that it can be, inasmuch as they are required to display and pass out for comment any changes in the type of services which they intend to offer. If the Fed is required to lay out its master plan or its strategy for market share over the next 5 years, this would certainly hinder any flexibility that they might have, I would think. I don't know of any large private sector bank that would be willing to lay out its strategy for the next 5 years and display it for all of us to see.

Accounting has a theoretical as well as a practical side and cost accounting techniques, like balance sheet ratios, can raise as many questions as they attempt to settle. The same questions, when directed toward private sector financial institutions would no doubt generate many different answers regarding equity allocations, capital adequacy, and attendant methods of allocating overhead and so forth.

The subject of presentment fees will probably bring a more uniform response among community bankers. We succumbed years and years ago to payment at par for on us items. The courts are very clear on this subject. I think the function of presentment fees is to exact a fee from a nondepository institution for presenting on us items outside of normal clearinghouse arrangements. Whether the form assumes a per item charge or percentage of face amount charge seems immaterial. While it would be nice to see presentment fees banned altogether, it may be just as well to wait and watch, at least for a short while, and perhaps they will continue to die of their own accord as we see more and more reciprocity agreements between the larger institutions take place.

I think it might be well to ask the question: Where is the noise regarding presentment fees coming from? How many banks are really involved in exacting presentment fees and what segment of the industry really thinks that this is an important aspect of their income stream?

I noticed in reading the GAO report that the Federal Reserve Bank of San Francisco back in 1978 not only went to nonpresentment, but they used the UCC and apparently presented items up until 2 o'clock in the afternoon, as you're entitled to do under the UCC. I don't recall hearing a lot of objection to that practice, not nearly as much, for example, as we heard over the noon presentment when it came into being in March 1982. It was phased in in February and May.

I think perhaps this can be looked back on as a nonevent. There was a tremendous amount of fanfare over this. The large banks said we're going to have to buy millions of dollars of equipment and make large capital expenditures. I don't recall that these things took place. It was all a smokescreen. Noon presentment came off with little or no problem.

I think Chris is right that the volume of checks dropped substantially because of the local clearinghouse being instituted. I know in our community there are three banks, and when explicit charges came into being we immediately started clearing again because we had been able to dump these items on the Fed without charge prior to that time. It represents a significant volume that no longer goes out of the local community.

ENHANCEMENTS TO PRESENT SYSTEM

Enhancements to the existing payments system will no doubt prove very interesting over the next few years. MICR line enhancements, check truncation, the development of national ATM networks, electronic check collection, and accelerated return item processing are items which lead to the ultimate objective in improving the system by substituting electronic for paper-based means of payment. Our country is demanding this at the present time. I think this is evidenced by the filing of Senate bill 2181.

If community banks are to remain viable financial entities, they must move forward as full participants in the payments system. There presently exists a fear among some bankers that national ATM networks will develop on an exclusive basis to the detriment of independent banks. If this is the case, the role of the Fed may be very important to insure that a cooperative management approach is used. The Fed's extensive communication system suggests that the System can play a central role in moving the payments mechanism toward the adoption of more efficient electronic technologies. At the same time, the System can fulfill an important social role to insure that all institutions, both large and small, have access to the rapidly emerging EFT system.

Evidence of strong resistance to the presence of the Fed in the payments system manifests itself in various ways. I think here, through criticisms of pricing techniques. It is felt by the Independent Bankers Association that pricing can be monitored, can be measured, can be adjusted to comply fairly with techniques and accounting practices acceptable to the private sector. The GAO, for example, is a fine and acceptable sounding board for this purpose and I think that the work that they've done is overwhelming. The depth of expertise that they have exercised is very apparent and I think it's a tremendous document. I've been reading through it in the last few days and I'm very impressed with the work that they've done, and I hope everybody has the opportunity and takes the time to read that.

The payments mechanism is certainly not static. It is fair to look to the private sector as well as the Fed to look through the mechanical aspects of pricing and ask who it is that is promoting the innovations in this system to keep up with the advancement of technology and help insure the necessary continued access to the

system for more than just a few. The price of not doing this cannot be measured just in dollars. Our banking structure is large and very complex, and embraces thousands of institutions.

One thing I might mention is that the Fed, while it has started pricing its services, has also prompted better pricing in the private sector and more explicit disclosure of the pricing techniques of the correspondent banks. One of my favorite correspondents happens to be the First National Bank of Minneapolis. We use their services extensively and they now put out a brochure on cash management services and their availability schedules, and they lay them out graphically and put their cutoff time, and these are the kind of documents that didn't exist a few years ago. I think pricing was certainly more explicit in the correspondent network as compared to the implicit pricing that we had in the Fed System, but pricing—for example, account analysis schedules never came across your desk unless you called and asked for them explicitly. Now they're mailed out on a monthly basis. So there's some good that's come out of this in the private sector as well.

The Fed has a difficult role to play in our system. It must provide its services efficiently and effectively, showing sincere interest in providing for the needs of all of its constituent financial institutions. It must fulfill its mandates from Congress, reducing float and improving efficiencies, while it prices its services fairly with private sector competitors who monitor its activities vigorously, watching intently for any improprieties. Indeed, it's not a very enviable situation to attempt to manage, but I think the Fed can be applauded in the progress it's made over the last few years.

In conclusion, the IBAA supports the Fed's efforts to continue its vital, active role in the Nation's payments system. The Nation's smaller banks are counting on the Fed to carry out its mandate to price its services properly and to improve the efficiency of the payments system.

[The complete statement follows:]

S T A T E M E N T

Of

O. J. TOMSON, President
Citizens National Bank
Charles City, Iowa
and
Chairman, Bank Operations Committee
INDEPENDENT BANKERS ASSOCIATION OF AMERICA

Before The

COMMITTEE ON BANKING, HOUSING & URBAN AFFAIRS
UNITED STATES SENATE

on

FEDERAL RESERVE SYSTEM PRICING OF CHECK CLEARING ACTIVITIES

APRIL 11, 1984

Chairman Garn, and members of the Senate Banking Committee:

It is a privilege to appear before this Committee to offer testimony on the Federal Reserve pricing of check clearing activities. My name is O. J. Tomson, and I serve as President of the Citizens National Bank of Charles City, a $50 million bank located in a community of 9,000 in Northeast Iowa. As a representative of the Independent Bankers Association of America, I serve as a spokesman for the 7,000 plus member banks of our organization who, by and large, are the smaller community banks located throughout suburban and rural America.

The vast majority of community bankers view the Fed's role in the payments system as essential, continuing, and extremely important to the ongoing stability and improvement of this very significant aspect of the financial framework of our nation. The dollar volume of checks cleared through the Federal Reserve System's regional banks and related facilities in 1983 exceeded $8.4 trillion. Check volumes in 1983 exceeded 12.9 billion processed items. And this only represents a segment of the total, with the balance being cleared through the correspondent bank network.

When the Federal Reserve Act became law in 1913, Congress specifically requested that the System establish a nationwide check clearing network to eliminate inefficient payment

practices and promote the payment of checks at par value. While it has over the years attempted to do this, the charge from Congress as set forth in Section 107 of the Monetary Control Act of 1980 made a much more explicit directive to the Fed than had existed prior to that time. The 1980 Act also served to enlarge the Fed's constituency and established the phase-in of universal reserves, making the differentiation between membership and non-membership in the system a rather meaningless distinction.

For those of us who are country bankers, the mandates of the 1980 Act were most positive because they caused the Federal Reserve System to re-evaluate its role as a provider of services. The system for too many years had been oriented toward serving the needs of the very large banks. We felt that it had become stuffy and that it did not cater to the needs of the small banks of this nation.

But, all of a sudden, with a greatly enlarged constituency including 40,000 plus financial institutions in the nation, a new era was ushered in. The Fed focused on its expanded market as it was directed to do by Congress and set out to meet the goals and objectives of the Monetary Control Act.

Why do community bankers view the actions of the Fed in a positive way and why do we buy their services when we have the

alternative of going to the private sector? Because after 70 years under the Federal Reserve Act, we still see abuses being promulgated by the private correspondent banks and practices being continued and inefficiencies being encouraged and marketed which we feel are contrary to the public good.

For example, the community banks of this nation are by and large collector banks. The vast majority of us are geographically remote from the Federal Reserve or correspondent depository facilities and must rely daily on both ground and air transportation to present remittance letters for collection. Our customers are the victims of the so-called controlled disbursement tactics of the money center banks who have taught the corporate treasurers so well the profit opportunities available to their respective companies by drawing their firms' checks on branches of those large banks (rather than our own) that are conveniently located one day outside of a money market clearing house. Of course, the correspondent bank also obtains the benefits of those delaying tactics.

We don't fault our large bank competitors for trying to make money. They're in business for that purpose. And that's what we're in business for. To make a profit. But we're not inclined to relegate ourselves into relying entirely upon a correspondent, who may be a formidable competitor for our

deposit and loan business and whose conduct to us may at times be suspect, to sell to us such a significant aspect of the services we are required to purchase because of the nature of our business.

We need a viable alternative source where we can purchase needed services. And this is what the Federal Reserve Act authorized and what the Monetary Control Act of 1980 reaffirmed. Basic arguments for the Fed's continued presence that I can recite are these:

1. The geographic expanse of this nation is immense with many institutions in remote locations needing services;

2. The large number of financial institutions and their growing degree of competititon presents some unique intra-industry problems;

3. The even hand of a federal regulator is obviously necessary to deal with the continuing problems of float reduction because only the regulator is removed from the self interest conflicts arising from related profit opportunities;

4. The Fed's role in the check clearing process serves as a natural adjunct to its role as a central banker.

Is the Fed, in the pricing of its check clearing services, competing fairly with the private sector? To answer this adequately presumes a lot of knowledge on the part of persons providing the answer. It does appear and the recent report from the General Accounting Office affirms, that the Fed is doing a very conscientious job of internal cost accounting, improving its accounting techniques with time, and attempting to properly allocate overhead. Accounting has a theoretical as well as a practical side and cost accounting techniques, like balance sheet ratios, can raise as many questions as they attempt to settle. The same questions, when directed toward private sector financial institutions, would no doubt generate many different answers regarding equity allocations, capital adequacy, and attendant methods of allocating overhead, etc.

The subject of presentment fees will, however, elicit a more uniform response among community bankers. We succumbed years ago to payment at par for on us items. The courts are clear on this subject. The function of presentment fees is to exact a fee from a non-depository institution for presenting on us items outside of normal clearing house arrangments. Whether the form assumes a per-item charge or percentage of

face amount charge seems immaterial. While it would be nice to see presentment fees banned, it may be just as well to watch, for at least a short while, and they may well continue to die of their own accord as more and more reciprocity agreements between correspondent banks come into being.

Enhancements to the existing payments system will no doubt prove very interesting. MICR line enhancements, check truncation, the development of national ATM networks, electronic check collection, and accelerated return item processing are items which lead to the ultimate objective in improving the system by substituting electronic for paper-based means of payment.

If community banks are to remain viable financial entities, they must move forward as full participants in the payments system. There presently exists a fear among some bankers that national ATM networks will develop on an exclusive basis to the detriment of independent banks. If this is the case, the role of the Fed may be very important to insure that a cooperative management approach is used. The Fed's extensive communication system suggests that the System can play a central role in moving the payments mechanism towards the adoption of more efficient electronic technologies. At the same time, the System can fulfill an important social role to insure that all institutions, both large and small, have access

to the rapidly emerging EFT system.

Evidence of strong resistance to the presence of the Fed in the payments system manifests itself in varous ways; here, through criticisms of pricing techniques. It is felt by the IBAA that pricing can be monitored, measured, and adjusted to comply fairly with techniques and accounting practices acceptable to the private sector. The GAO, for example, is a fine and acceptable sounding board established for this very purpose.

The payments system is not static. It is fair to look to the private sector as well as the Fed to look through the mechanical aspects of pricing and ask who it is that is promoting the innovations in this system to keep up with the advancement of technology and help insure the necessary continued access to the system for more than just a few. The price of not doing this cannot be measured in just dollars. Our banking structure is large and very complex, embracing thousands of institutions.

The Fed has a difficult role to play in our system. It must provide its services efficiently and effectively, showing sincere interest in providing for the needs of all of its constituent financial institutions. It must fulfill its mandates from Congress, reducing float and improving

efficiencies, while it prices its services fairly with private sector competitors who monitor its activities vigorously, watching intently for any improprieties. Indeed, this is not a very enviable situation to manage.

In conclusion, the IBAA supports the Fed's efforts to continue its vital, active role in the nation's payments mechanism. The nation's smaller banks are counting on the Fed to carry out its mandate to price its services properly and to improve the efficiency of the payments system.

The CHAIRMAN. Thank you, Mr. Tomson.

Mr. Murphy, you recommend that Congress repeal the law which prevents banks from imposing presentment fees on the Federal Reserve Banks. You say, "The workings of the marketplace will determine what will happen if the exemption is repealed," and you indicate that this is the way it should be.

Do you also favor repeal of the ban on credit card surcharges so that the workings of the marketplace can determine how the cost of credit cards should be assessed?

Mr. MURPHY. First, let me speak to the presentment fee issue. I think we'd rather see that it be permissible for the bank to pay presentment fees whether or not they had historically been charged. I don't know that the marketplace necessarily would cause such charges to be assessed but I believe that if such charges were assessed, these costs would force further clearings into the clearinghouses.

With regard to surcharges, I can only speak for myself personally. I can't speak for the association since I don't represent the association with regard to surcharges, but I am not in favor of surcharges.

LET THE MARKETPLACE DECIDE

The CHAIRMAN. Well, the point I was trying to make is you were suggesting the marketplace should decide. I don't think too many people would charge surcharges is the point. What we have attempted to do here in the Senate is to let the marketplace decide. If somebody wants to put on a surcharge, that's their business. If they're not competitive, so be it, if some other merchant does not put it on. We're in a great argument over that issue right now between the Senate and the House, and I have a difficult time understanding why Government should say, "You cannot"—the way it's presented by American Express and those who have a stake in this is the indication to all their card holders and so on is a requirement—that isn't exactly what they say, but that's the way it comes out. And it's simply saying that a merchant can do what they want

in determining how much credit costs. If that means cash discounts, fine. If that means no cash discounts or a surcharge, they can make that decision in the marketplace.

Mr. MURPHY. I think I personally would support that very much. Certainly in our own case we changed gas stations on the basis of surcharges.

The CHAIRMAN. In his statement this morning William Anderson suggested the private sector competitors have certain advantages over the Fed in the check clearing business,

> A private bank can, but a Federal Reserve bank cannot, charge very high prices to discourage demand for services the bank feels do not represent the best use of the bank's resources. Furthermore, unlike its private competitors, the Federal Reserve is not in a position to market its check clearing services as part of a broader array of service lines that would define a total business relationship between respondent and correspondent banks.

How would you respond to those statements, Mr. Tomson?

Mr. TOMSON. I tend to agree with those statements. The Fed must operate as though they are in a clear goldfish bowl. Their prices and charges and everything are laid out face up for everybody to examine.

A private sector institution can pick and choose. For example, if they want to entirely discourage the clearing of nonencoded items, they can so do by merely raising their price on exception items to the point where you would not do business with them. It's similar to the question which you just posed earlier—you go someplace else in the marketplace.

I don't feel that the Fed has that opportunity to be that arbitrary. They do not enjoy that flexibility.

The CHAIRMAN. Mr. Tomson, the ABA statement argues that the Fed prices for check clearing services are still too low and the cost of capital adjustment to the PSAF is too low. Do you agree?

Mr. TOMSON. Well, they're using at this time I believe a suggested pretax figure of 17.2 percent and an after-tax figure that translates into 13.7 percent, and that range would appear reasonable in light of the comparisons they are using. They have taken 25, I think, of the largest holding companies in this country and looked at their historical earnings, their return on equity. I think it's reasonable.

I look at a large telecommunications company, for example, Northwest Bell. They're not allowed to make this much return on capital presently in the State of Iowa. Now they are presently appearing before the Commerce Commission in our State asking that that be increased. I believe they are asking for approximately 16 percent.

I mentioned that in a rural environment, we like to see a 15-percent return. One of the things to think about with a large corporate entity, whether it be a private sector bank or the Federal Reserve, when it's got millions and millions of dollars invested in the type of capital assets that they have, there's no opportunity to liquidate those assets and realize their cash on their capital. They have to look at the future anticipated earnings capacity of those assets and hopefully get a fair return in order to justify the investment. We could perhaps debate all day on just how we find that to be. I think the GAO has done a commendable job in looking at it

and trying to spell it out and bring it out as best they can. They don't disagree with it and I don't have any reason to take exception with their findings.

The CHAIRMAN. Mr. Murphy, as an example of continued need for a Fed presence in the check clearing process, Mr. Corrigan stated this morning that the Fed can assume the risk of acting as a correspondent for a troubled institution but a private sector firm could not or should not assume such risk.

Would you agree with Mr. Corrigan on that?

Mr. MURPHY. I would agree basically with the statement. A private firm could. Whether it should or whether it would is another matter. Certainly it probably would not assume that responsibility whereas the central bank would. In that case, I think he's correct.

The CHAIRMAN. Gentlemen, thank you very much. We appreciate your willingness to testify today.

The committee is adjourned.

[Whereupon, at 11:40 a.m., the hearing was adjourned.]

[Additional material supplied for the record follows:]

Credit Union National Association, Inc.
1730 RHODE ISLAND AVE. N.W. • WASHINGTON, D.C. 20036 • 202-828-4500

April 10, 1984

The Honorable Jake Garn
Chairman
Committee on Banking, Housing and Urban Affairs
SD 534
United States Senate
Washington, DC 20510

Dear Chairman Garn:

On behalf of the Credit Union National Association, Inc., we submit the following written comments with regard to the Federal Reserve System's fees for check clearing and settlement services. We would appreciate it if this material could become part of the record for the hearing that occurs on April 11, 1984. Many of these same comments were made to a House subcommittee in 1983, which also was interested in this subject.

Summary

My statement makes the following points:

- The Federal Reserve's central position in our country's payments mechanism--as the locus around which the nation's clearings and settlements occur--requires a public sector presence. These cannot be delegated or otherwise assumed by the private sector without creating inequities and the potential for substantial abuse.

- Prior to the passage of the Depository Institutions Deregulation and Monetary Control Act of 1980, P.L. 96-221, credit unions were required to gain access to the Federal Reserve's clearing and settlement facilities through the banking industry. Now that credit unions have direct access to the payments mechanism though the Federal Reserve (as any other financial intermediary), our availability of funds has improved, our transaction costs have declined, and 50 million consumers--as members of credit unions nationwide--have benefited.

- We believe the Federal Reserve's role in the nation's clearing and settlement activities complements its central bank functions.

- We have reviewed the Federal Reserve's pricing schedules, its cost allocation methods, including the private sector adjustment factor, and its mandated legislative requirements with regard to pricing. We find no evidence that the Federal Reserve has underpriced its services nor that it has otherwise disadvantaged the banking industry nor other financial intermediaries.

Remarks

We very much appreciate the opportunity to submit this statement on pricing of the Federal Reserve's services. The issues addressed are of vital concern to our industry and the 50 million consumers served by the nation's nearly 20,000 credit unions.

To begin, we would like to place in context the role that the Federal Reserve System plays in the nation's payment system.

The expenditures that the Federal Reserve incurs in its check clearing and electronic transfer activities are very small compared to the amount that the nation as a whole spends for such activities. Likewise, the proportion of operations that the Federal Reserve conducts is very small when compared to that of all other participants, including financial depositories, intermediaries, and third-party vendors of various types. However, the importance of those Federal Reserve System activities--particularly with respect to ensuring the equitable access and participation of all depository institutions in the nation's payments mechanism--is of much greater significance. This is the underlying issue of these hearings.

The Federal Reserve traditionally has provided two basic payments-related activities:

(1) through the central bank's system of reserve accounts and clearing balances, it has made it possible for any financial depository to settle with any other depository, and

(2) through its transportation and communications networks, it has made it possible for any financial depository to clear payment instruments and electronic transfers on any other depository.

Thus, it has not been necessary for each of the 20,000 credit unions, 14,000 banks, 3,500 savings and loans, and 400 mutual savings banks to settle and clear items directly with each other. If each of these depositories had to settle and clear directly with each other, our nation's financial institutions would have to maintain 860 million account relationships--clearly an unmanageable number. In order to have

a workable payments system, either the Federal Reserve must continue to provide those settlement and clearing activities that are central to the efficient and effective operation of the nation's payments mechanism, or the private sector, notably the large commercial banks, must assume those functions. Those functions carry with them enormous responsibilities, because the provider of the settlement and clearing activities is in a position to control access to the nation's payment system and to set the price, terms, and conditions for its use. Because of the monopoly power inherent in these settlement and clearing functions, we believe these properly belong in the public sector. Credit unions' own experiences with the payment mechanism also confirm that this responsibility best rests with the Federal Reserve.

Before passage of the Monetary Control Act in 1980, credit unions were required to use commercial banks to gain access to the Federal Reserve's clearing and settlement facilities. Now they have direct access to these facilities under the same terms and conditions as any other financial depository, no matter how large or small. As a result, credit unions nationwide have found that their availability of funds in check clearing has improved substantially; their transaction costs have fallen and the resulting additional earnings and cost savings have been passed on to our 50 million members. Some examples may be useful in providing insight on the magnitude of the improvements that direct access to the Federal Reserve has brought since passage of the Depository Institutions Deregulation and Monetary Control Act.

Prior to the Monetary Control Act, banks charged credit unions $10-$25 per wire transfer, with the average being about $15. Some credit unions were charged for both wires out and for wires in, the latter a deposit. Today, credit unions have wire transfer services available from their corporate credit unions at an average charge of $3.50 for wires out, and no charge for wires in.

Before the Act, credit unions requiring securities safekeeping services had to purchase such services from commercial banks. Some banks collected per item charges, some compensating balances, and some collected both from credit unions. Since passage of the Act, the credit union industry has initiated its own security safekeeping services at less than half of the charges that credit unions paid banks for similar services. In addition, we require no compensating balances.

By far the largest gain to credit unions is from improved availability of funds. Credit unions have begun to deposit their items for collection directly with the Federal Reserve and to receive funds according to the published schedules of the Reserve Banks. Our members are benefitting directly from being able to receive funds more quickly.

Such direct and equitable participation in the payments system has enabled our industry to move money far more efficiently than in the past. It has made it possible for us to innovate in the clearing of share drafts. We have also initiated electronic payment services through the Federal Reserve's automated clearing facilities. We have 5,000 credit unions in the program and expect to significantly expand such services, including direct deposit and bill-paying arrangements. Our industry is also constructing an electronic payments network linking credit unions nationwide as a means of further reducing transaction costs to our members.

We would like to make some additional points:

One, we see no contradiction between the role that the Federal Reserve plays as a regulator and as a traditional provider of settlement and clearing activities. In this latter capacity, we find it difficult to consider the Federal Reserve a competitor to the private sector. We know of no one other than the Federal Reserve that will, for example, accept a share draft, check, or other draft for collection drawn on any depository institution in the nation, regardless of location, deliver the item to that institution for collection, and guarantee availability of funds under a uniform set of terms, conditions and prices. As a result of this policy, credit unions have begun to perform correspondent services for other credit unions and for other financial depositories. We consider our direct access to the Federal Reserve's settlement and clearing facilities as essential and complementary to such correspondent services, and beneficial to our consumer members.

Two, we believe the Federal Reserve's role in check clearing complements its central bank functions. We would be very uncomfortable if large banks became the focus of activity for the nation's settlements and clearings. For that matter, we would be very uncomfortable if any competitor assumed the centralized and commanding role now held by the Fed--and our concern would be exacerbated if that competitor participated in the myriad of activities that link-up with and rely upon the central settlement and clearing functions now performed by the Fed.

Three, we have reviewed the Federal Reserve's pricing schedules and pricing proposals and its cost allocation system, including the private sector adjustment factor. We find no evidence that the Federal Reserve has subsidized its services other than that which it indicated it intended to, namely, the ACH.

Four, the charging of presentment fees by certain banks to correspondents may be related to other factors than the costs of clearing. Therefore, we believe that the Federal Reserve should not be required to include such charges in its price for clearing checks.

Ultimately, such charges would have to be borne by consumers whose depository institution's collect their checks through the Federal Reserve. We believe it is inappropriate to transfer the costs associated with a banking industry problem to the consumer. Further, among other problems, presentment fees raise questions concerning non-par banking.

Five, we support any enhancements that the Federal Reserve undertakes to eliminate float prior to pricing for its float. Such a move will ensure that the consumer will not be burdened with more than his fair share of the cost of float in the allocation process. Therefore, we support noon presentment as it enables more items and dollars to clear in a timely manner.

Six, we were very disappointed when the Federal Reserve abandoned its efforts to truncate large dollar value items and to collect such items electronically. Credit unions pioneered in the truncation of share drafts. Today, over 1 billion of such consumer items are truncated annually. Such truncation eliminates laborious manual handlings as well as surface and air transportation of paper, and replaces these with electronic processing and delivery. We believe our industry has proven that truncation is a preferred means of processing payments and that it reduces consumer transaction costs.

We are aware that 7% of the items collected in the nation represent 85% of the dollars, and that such large dollar items primarily are commercial and not consumer items. Truncation and expedited collection of these would not only reduce float, but it would also be a deterrent to remote disbursement arrangements that are deliberately intended to slow payment. Further, it would help consumers receiving checks and drafts originated by commercial organizations to get their funds more quickly by substantially reducing the rationale used by some depositories for withholding the availability of such money.

Finally, we support the Federal Reserve's program to achieve nationwide automation of return items. We believe that such a program should be given a high priority. The absence of such automated processing of returns requires our industry to engage in a very inefficient return operation in the processing of member share drafts. Under current arrangements, we truncate the paper item, convert the item to an electronic image, and use the electronic image to post the charge to a member's account. For return items, however, we are required to convert the electronic image back to a paper item--and that is a step backward in our view. The technology currently exists to enable returns to be handled electronically. But we understand that an accommodating legal framework is necessary to put this technology to use. We urge this committee to develop such a framework to the benefit of all participants in the payments mechanism -- particularly consumers.

We are grateful for the opportunity to present our perspective on these vitally important issues.

Sincerely,

Jim Kudlinski
Chief Operating Officer
U.S. Central Credit Union

JK:jlt

U.S. CENTRAL CREDIT UNION

CORPORATE WOODS
P.O. BOX 25097
OVERLAND PARK, KANSAS 66210 (913) 642-9520

April 6, 1984

The Honorable Jake Garn
Chairman
Committee on Banking, Housing and Urban Affairs
SD 534
United States Senate
Washington, DC 20510

Dear Chairman Garn:

On behalf of the Credit Union National Association, Inc., we submit the following written comments with regard to the Federal Reserve System's fees for check clearing and settlement services. We would appreciate it if this material could become part of the record for the hearing that occurred on April 6, 1984. Many of these same comments were made to a House Subcommitee in 1983, which also was interested in this subject.

Summary

My statement makes the following points:

- The Federal Reserve's central position in our country's payments mechanism--as the locus around which the nation's clearings and settlements occur--requires a public sector presence. These cannot be delegated or otherwise assumed by the private sector without creating inequities and the potential for substantial abuse.

- Prior to the passage of the Depository Institutions Deregulation and Monetary Control Act of 1980, P.L. 96-221, credit unions were required to gain access to the Federal Reserve's clearing and settlement facilities through the banking industry. Now that credit unions have direct access to the payments mechanism though the Federal Reserve (as any other financial intermediary), our availability of funds has improved, our transaction costs have declined, and 50 million consumers--as members of credit unions nationwide--have benefited.

- We believe the Federal Reserve's role in the nation's clearing and settlement activities complements its central bank functions.

- We have reviewed the Federal Reserve's pricing schedules, its cost allocation methods, including the private sector adjustment factor, and its mandated legislative requirements with regard to pricing. We find no evidence that the Federal Reserve has underpriced its services nor that it has otherwise disadvantaged the banking industry nor other financial intermediaries.

Remarks

We very much appreciate the opportunity to submit this statement on pricing of the Federal Reserve's services. The issues addressed are of vital concern to our industry and the 50 million consumers served by the nation's nearly 20,000 credit unions.

To begin, we would like to place in context the role that the Federal Reserve System plays in the nation's payment system.

The expenditures that the Federal Reserve incurs in its check clearing and electronic transfer activities are very small compared to the amount that the nation as a whole spends for such activities. Likewise, the proportion of operations that the Federal Reserve conducts is very small when compared to that of all other participants, including financial depositories, intermediaries, and third-party vendors of various types. However, the importance of those Federal Reserve System activities--particularly with respect to ensuring the equitable access and participation of all depository institutions in the nation's payments mechanism--is of much greater significance. This is the underlying issue of these hearings.

The Federal Reserve traditionally has provided two basic payments-related activities:

(1) through the central bank's system of reserve accounts and clearing balances, it has made it possible for any financial depository to settle with any other depository, and

(2) through its transportation and communications networks, it has made it possible for any financial depository to clear payment instruments and electronic transfers on any other depository.

Thus, it has not been necessary for each of the 20,000 credit unions, 14,000 banks, 3,500 savings and loans, and 400 mutual savings banks to settle and clear items directly with each other. If each of these depositories had to settle and clear directly with each other, our nation's financial institutions would have to maintain 860 million account relationships--clearly an unmanageable number. In order to have

a workable payments system, either the Federal Reserve must continue to provide those settlement and clearing activities that are central to the efficient and effective operation of the nation's payments mechanism, or the private sector, notably the large commercial banks, must assume those functions. Those functions carry with them enormous responsibilities, because the provider of the settlement and clearing activities is in a position to control access to the nation's payment system and to set the price, terms, and conditions for its use. Because of the monopoly power inherent in these settlement and clearing functions, we believe these properly belong in the public sector. Credit unions' own experiences with the payment mechanism also confirm that this responsibility best rests with the Federal Reserve.

Before passage of the Monetary Control Act in 1980, credit unions were required to use commercial banks to gain access to the Federal Reserve's clearing and settlement facilities. Now they have direct access to these facilities under the same terms and conditions as any other financial depository, no matter how large or small. As a result, credit unions nationwide have found that their availability of funds in check clearing has improved substantially; their transaction costs have fallen and the resulting additional earnings and cost savings have been passed on to our 50 million members. Some examples may be useful in providing insight on the magnitude of the improvements that direct access to the Federal Reserve has brought since passage of the Depository Institutions Deregulation and Monetary Control Act.

Prior to the Monetary Control Act, banks charged credit unions $10-$25 per wire transfer, with the average being about $15. Some credit unions were charged for both wires out and for wires in, the latter a deposit. Today, credit unions have wire transfer services available from their corporate credit unions at an average charge of $3.50 for wires out, and no charge for wires in.

Before the Act, credit unions requiring securities safekeeping services had to purchase such services from commercial banks. Some banks collected per item charges, some compensating balances, and some collected both from credit unions. Since passage of the Act, the credit union industry has initiated its own security safekeeping services at less than half of the charges that credit unions paid banks for similar services. In addition, we require no compensating balances.

By far the largest gain to credit unions is from improved availability of funds. Credit unions have begun to deposit their items for collection directly with the Federal Reserve and to receive funds according to the published schedules of the Reserve Banks. Our members are benefitting directly from being able to receive funds more quickly.

Such direct and equitable participation in the payments system has enabled our industry to move money far more efficiently than in the past. It has made it possible for us to innovate in the clearing of share drafts. We have also initiated electronic payment services through the Federal Reserve's automated clearing facilities. We have 5,000 credit unions in the program and expect to significantly expand such services, including direct deposit and bill-paying arrangements. Our industry is also constructing an electronic payments network linking credit unions nationwide as a means of further reducing transaction costs to our members.

We would like to make some additional points:

One, we see no contradiction between the role that the Federal Reserve plays as a regulator and as a traditional provider of settlement and clearing activities. In this latter capacity, we find it difficult to consider the Federal Reserve a competitor to the private sector. We know of no one other than the Federal Reserve that will, for example, accept a share draft, check, or other draft for collection drawn on any depository institution in the nation, regardless of location, deliver the item to that institution for collection, and guarantee availability of funds under a uniform set of terms, conditions and prices. As a result of this policy, credit unions have begun to perform correspondent services for other credit unions and for other financial depositories. We consider our direct access to the Federal Reserve's settlement and clearing facilities as essential and complementary to such correspondent services, and beneficial to our consumer members.

Two, we believe the Federal Reserve's role in check clearing complements its central bank functions. We would be very uncomfortable if large banks became the focus of activity for the nation's settlements and clearings. For that matter, we would be very uncomfortable if any competitor assumed the centralized and commanding role now held by the Fed--and our concern would be exacerbated if that competitor participated in the myriad of activities that link-up with and rely upon the central settlement and clearing functions now performed by the Fed.

Three, we have reviewed the Federal Reserve's pricing schedules and pricing proposals and its cost allocation system, including the private sector adjustment factor. We find no evidence that the Federal Reserve has subsidized its services other than that which it indicated it intended to, namely, the ACH.

Four, the charging of presentment fees by certain banks to correspondents may be related to other factors than the costs of clearing. Therefore, we believe that the Federal Reserve should not be required to include such charges in its price for clearing checks.

Ultimately, such charges would have to be borne by consumers whose depository institution's collect their checks through the Federal Reserve. We believe it is inappropriate to transfer the costs associated with a banking industry problem to the consumer. Further, among other problems, presentment fees raise questions concerning non-par banking.

Five, we support any enhancements that the Federal Reserve undertakes to eliminate float prior to pricing for its float. Such a move will ensure that the consumer will not be burdened with more than his fair share of the cost of float in the allocation process. Therefore, we support noon presentment as it enables more items and dollars to clear in a timely manner.

Six, we were very disappointed when the Federal Reserve abandoned its efforts to truncate large dollar value items and to collect such items electronically. Credit unions pioneered in the truncation of share drafts. Today, over 1 billion of such consumer items are truncated annually. Such truncation eliminates laborious manual handlings as well as surface and air transportation of paper, and replaces these with electronic processing and delivery. We believe our industry has proven that truncation is a preferred means of processing payments and that it reduces consumer transaction costs.

We are aware that 7% of the items collected in the nation represent 85% of the dollars, and that such large dollar items primarily are commercial and not consumer items. Truncation and expedited collection of these would not only reduce float, but it would also be a deterrent to remote disbursement arrangements that are deliberately intended to slow payment. Further, it would help consumers receiving checks and drafts originated by commercial organizations to get their funds more quickly by substantially reducing the rationale used by some depositories for withholding the availability of such money.

Finally, we support the Federal Reserve's program to achieve nationwide automation of return items. We believe that such a program should be given a high priority. The absence of such automated processing of returns requires our industry to engage in a very inefficient return operation in the processing of member share drafts. Under current arrangements, we truncate the paper item, convert the item to an electronic image, and use the electronic image to post the charge to a member's account. For return items, however, we are required to convert the electronic image back to a paper item--and that is a step backward in our view. The technology currently exists to enable returns to be handled electronically. But we understand that an accommodating legal framework is necessary to put this technology to use. We urge this committee to develop such a framework to the benefit of all participants in the payments mechanism -- particularly consumers.

We are grateful for the opportunity to present our perspective on these vitally important issues.

Sincerely,

Jim Kudlinski

Jim Kudlinski
Chief Operating Officer
U.S. Central Credit Union

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